

TERRORIST RESPONSES TO IMPROVED U.S. FINANCIAL DEFENSES

HEARING BEFORE THE SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS OF THE COMMITTEE ON FINANCIAL SERVICES U.S. HOUSE OF REPRESENTATIVES ONE HUNDRED NINTH CONGRESS FIRST SESSION

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TERRORIST RESPONSES TO IMPROVED U.S. FINANCIAL DEFENSES

Wednesday, February 16, 2005

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to call, at 10:04 a.m., in Room 2128, Rayburn House Office Building, Hon. Sue Kelly [chairwoman of the subcommittee] presiding.

Present: Representatives Kelly, Kennedy, Price, Fitzpatrick, Gutierrez, Moore of Kansas, Maloney, Cleaver, Scott, Wasserman Schultz, and Moore of Wisconsin.

Also present: Representatives Royce and Feeney.

Chairman KELLY. [Presiding.] This hearing of the Subcommittee on Oversight and Investigations will come to order.

Since September 11, 2001, the Subcommittee on Oversight and Investigations has conducted a series of hearings on terrorist finance. This subcommittee has led efforts to improve our financial defenses and shut off the flow of terrorist money into this country. Working with the Treasury Department, we have created the Office of Terrorism and Financial Intelligence and increased the resources available to FinCEN, OFAC, and the Office of Intelligence Analysis. Since the attacks on our country, our financial defenses have improved dramatically. We are constantly making strides forward and discouraging terrorists and international criminals from using our financial systems against us.

The global war on terror is a dynamic process, however, and our foe is ruthless and cunning. The improved state of our financial defenses requires Al Qaida and its allies to find new means to carry out their ends. In turn, our own nation must ensure that new financial routes do not become safe havens for terrorist finance.

Finally, we must make sure that our efforts to detect and prevent money laundering and terrorist finance do not drive out legitimate cash-handling institutions, drive them out of business. I appreciate Secretary Snow and Under Secretary Levey's recent public comments on this issue. The U.S. does not have the resources to police all monetary transactions for money laundering and terrorist connections. In West Africa, South Asia, and the Middle East, cooperation with local regulators and financial institutions is essential for achieving our policy goals. Multilateral associations such as the Financial Action Task Force and the Egmont Group can help facilitate this cooperation.

FATF is a group of 33 nations, including the United States, that develop anti-money laundering policy and best practices. The Egmont Group consists of 94 financial intelligence units from around the world who share information on terrorist financing and money laundering. Encouraging the creation of the FIUs and strengthening their information-gathering capacities is essential to tracking changes in the terrorist financial activities.

Unfortunately, not all nations that are committed to establishing an FIU have done so, leaving a gap in our ability to fight terrorism and threatening relations with nations that do not match their words with actions against our mutual enemies. An example of the important role an FIU might play arose earlier this month. New reports emerged that Arab Bank in New York was being used to transmit funds from Saudi Arabia, convert them to dollars or shekels, and then transmit them as rewards to the families of terrorist bombers. This reported that families would simply present martyrdom certificates at Arab Bank branches and receive compensation. From what I have seen, when they present these martyrdom certificates, the Arab Bank would then list that they had given \$7,000 to the family or 20,000 shekels to a family that had in fact had a child or a family member who had blown themselves up, and in the process blown up other people.

There is a price that has been paid to people to kill others through the Arab Bank branches, as far as we can see. If that is true, perhaps a Saudi FIU could have accelerated the flow of information to the U.S. so our Treasury Department and financial regulators could have responded and responded quickly. Perhaps there are other instances where the absence of a Saudi FIU slowed or entirely prevented action against terrorist activity. Saudi Arabia announced that it established an FIU in 2002. However, it appears that there was no corresponding action with this announcement. In August of 2004, Treasury Under Secretary Levey informed the financial services committee that the Saudi FIU had still not been established, despite their announcement in 2002. Today, more than 2 years after that announcement, it is quite reasonable to doubt that an operational Saudi FIU exists. There is a news report this morning where a Saudi spokesman states that an FIU has been established, and that to say otherwise disregards the facts.

This subcommittee recognizes Saudi Arabia as a critical ally in fighting terrorism, and welcomes any additional information that the Saudi Arabian government is willing to provide on the FIU issue and other matters which Mr. Royce and I have recently raised regarding terror finance initiatives. We share their deep interest in continuing strengthening the U.S.-Saudi partnership and fighting mutual enemies, but we will not be placated by press releases and glossy generalities. We will welcome future discussions on this matter.

The necessity of cooperation in fighting terror financing and encouraging governments to enforce the laws on their books cannot be denied. Our witnesses have first-hand experience in the difficulty of identifying nontraditional financial networks, of creating a climate of compliance that foreign regulators feel comfortable in, and of ensuring that communities are backed by action. One way to provide measurable evidence of a nation's cooperation with the

United States in stopping terror financing is to create a certification regime on terror finance. Such a measure would give our Treasury officials another tool in convincing their colleagues overseas of the necessity of fighting terror finance on their own and to reassure investors in compliant nations that their financial sectors are clean. I introduced legislation to create a certification regime in the last Congress and I will reintroduce this legislation for the committee's consideration again.

This morning, the committee will take testimony from three individuals with expertise on the current state of our financial defenses, those of our allies, and the areas in which terrorist financing may be moving in response to our new laws. Without objection, all members's opening statements are going to be made part of the record.

With that, I will turn to Mr. Gutierrez.

Mr. GUTIERREZ. Good morning. I want to thank Chairwoman Kelly for having this hearing, the first one for the Oversight Subcommittee in the 109th Congress. I want to extend a warm welcome to all the members of the subcommittee, some of whom are returning and others who are new to the subcommittee or new to the Congress.

It is particularly appropriate that the subcommittee's first hearing of this new Congress is focused on the issue of terrorist financing. Chairwoman Kelly and I have frequently worked together on this issue, both within the subcommittee and as founding members of the Terrorist Finance Task Force. Ensuring that Treasury has the necessary resources to perform its mandated functions is a high priority for us. We worked hard together last year to secure an additional \$25 million in funding for FinCEN. Given our history on this matter, I expect that we will continue our efforts on this issue, especially as we review the budget. I look forward to working with you, Chairwoman Kelly.

Today, I am pleased that we will be hearing from Assistant Secretary Juan Zarate, who is with us today only because his wife has not yet made him a father, which we understand could happen any second. I congratulate you, Mr. Zarate, and I have to say that being a father is the best job I have ever had. I wish you much luck and happiness.

I look forward to asking Mr. Zarate about the evolution of the current structure of the terrorist finance operations at Treasury. I also have some questions about the budget relating to his department, specifically regarding their computer system. In addition, we have been informed that a number of employees will be transferred from OFAC to the office of intelligence, and I would like to hear how this will affect the day-to-day operations.

I look forward to the testimony of the other witnesses. Mr. Malloy Factor points out in his testimony that the U.S. government should increase its information sharing with the financial services industry under the PATRIOT Act so that that industry may better understand how the data they provide are used. Coming from Chicago where I hear the word "commodities," I tend to think of corn and pork bellies as futures on the finest exchanges in the world, the Chicago Board of Trade and the Chicago Mercantile Exchange. Mr. Douglas Farah will talk about the use of commodities that do

not grow in the Midwest, particularly diamonds and their use in financing terrorism. I look forward to hearing from him about his research.

All of these witnesses have valuable experiences to share with the subcommittee. I am eager to hear their testimony, and I yield back to the gentlelady the balance of my time.

Chairman KELLY. Thank you very much, Mr. Gutierrez.

Mr. Royce?

Mr. ROYCE. Thank you, Chairwoman, for calling this important hearing.

I also want to welcome Juan Zarate. I think he brings considerable skill and a tremendous amount of institutional knowledge to cracking this problem. It is good to see somebody from Orange County leading this fight. The Chairwoman and I have developed I think a very good working relationship on terror finance issues. I know that we are both looking forward in serving on this subcommittee to continue building on that. I have been named the international relations chair for the subcommittee on terrorism and nonproliferation. I think there is a chance for us to hone in together, Chairwoman Kelly, on this important and critical issue.

Chairman KELLY. I look forward to that, Mr. Royce.

Mr. ROYCE. Thank you. Thank you. I think the United States has improved our financial defenses against terrorist operations. I think the Office of Terrorism and Financial Intelligence has been effectively formed within the Treasury Department. I think changes in money laundering law through the PATRIOT Act have proven vital. I think we in the Congress have also stepped up efforts on a bipartisan basis through the Congressional Anti-terrorist Financing Task Force. I commend Chairwoman Kelly, again, for her leadership on that.

However, money is the lifeblood of terrorists, and we should fully expect that as soon as we act to tighten our defenses in one area, that the terrorists will change their tactics and move in a different direction. We have to challenge ourselves at every step to think and act creatively. It is a chess match, and these are urgent issues. I think for those of us who have served in government for a while. We know that the U.S. governmental agencies typically have not proven as flexible as the ruthless terrorist groups targeting our nation. So I think a lot more energy on our part needs to go into thinking this through, hearing what additional tools individuals like Juan Zarate need in order to effectively outsmart our enemies, and we need to be prepared to give them those tools.

I look forward to your testimony. Thank you.

Chairman KELLY. Thank you very much, Mr. Royce.

Mr. Scott?

Mr. SCOTT. Thank you very much, Chairwoman Kelly. I certainly appreciate this hearing. It is a most important and timely hearing on a very, very vital issue.

This hearing today is an important review of efforts by the government and the financial industry to identify and eliminate terrorist financing. Since 9/11, several sectors of the financial industry, new cabinet offices, and task forces have been created to track and disrupt terrorist financing. While there has been some early success in closing down identified financing schemes, new methods

of transferring funds between terrorists and rogue nations or crime syndicates continue.

The United States must continue to improve financial intelligence in order to identify and track down terrorist cells and eliminate them once and for all. We must understand that closing one network provides incentives for another opportunity to transfer resources between cells. It is also imperative that our enforcement agencies continue to collaborate and not become entangled in bureaucratic differences.

Finally, I am concerned that several despotic nations have allowed lawless segments of their countries to become safe havens for terrorist operatives. We know who these countries are and we need to move forcefully to deal with these countries if the world is going to be safe from terrorism. We must not ignore the threats that have been brewing in some of the world's poorest countries. This is where the action is.

I look forward, Chairlady Kelly, to this hearing from this distinguished panel of witnesses, who will provide us with an update on current efforts to track terrorist financing.

Thank you.

Chairman KELLY. Thank you, Mr. Scott.

Ms. Moore?

MS. MOORE OF WISCONSIN. Thank you, Madam Chair, for recognizing me. I am a very new member to this committee and subcommittee, so I am very eager to hear from our witnesses today. I am hoping that throughout the testimony, particularly of our first witness, the Honorable Juan Zarate, that I will learn more about the structure and command of his division, and how you plan to use the increased funding for your department to explore the strategies for anti-terrorist financing.

You also have some vacancies in your department, and there is going to be some reorganization. I would be very interested in your focusing on that.

Thank you.

Chairman KELLY. Thank you, Ms. Moore.

Mr. Fitzpatrick?

Mr. FITZPATRICK. Thank you, Chairwoman Kelly.

To our distinguished panelists, thanks for taking the time to meet with us here today. Even though I am new to this committee, it is apparent that our government has made great strides to identify and prevent terrorists from using America's financial systems to support their activities. With the freezing of terrorist assets worth millions and millions of dollars, Americans are safer today than they were on September 11, 2001.

Despite the wide-ranging viewpoints in Congress, we can always stand together on one thing. We must continue to do everything in our power to prevent another terrorist attack. I commend the Treasury Department for its continued efforts to block the flow of terrorist funds to terrorist organizations. However, terrorist financiers are constantly adjusting to our domestic and our international efforts. They are finding inventive ways to finance terror with commodities that are difficult to track, like gold and diamonds. Despite extraordinary global efforts, in particular the Financial Action Task Force and the Egmont Group, I am concerned

that our efforts abroad are not sufficient. There are significant hurdles that remain before information flows seamlessly across nations.

I represent a district that was affected directly by the September 11 attack. Seventeen residents from Pennsylvania's eighth district were killed in the attack on the World Trade Center. The families of those 17 people that tragically died that day want these cowards brought to justice. It is critical that we never forget that our efforts to cut off terrorist organizations's funding will save lives of our constituents.

I yield back the balance of my time.

Chairman KELLY. Thank you.

Mr. Cleaver?

Mr. CLEAVER. Madam Chairperson, I am honored to have the opportunity to serve on this subcommittee. I believe the agenda is significant to the preservation of our way of life and I think it is one of the great responsibilities we have if we are successful in tracking down the source of dollars that go into the pockets of terrorists.

I look forward to working with you and the other committee members. Being new is sometimes a new experience.

Chairman KELLY. Thanks, Mr. Cleaver.

Mr. Moore?

Mr. MOORE OF KANSAS. Thank you, Madam Chair, and I thank the witnesses for being present. I just want to say that I learned a long time ago that I learn more when I listen than when I speak. So today, I am here to learn and not to speak.

Thank you.

Chairman KELLY. Thank you, Mr. Moore.

Ms. Wasserman Schultz?

Ms. WASSERMAN SCHULTZ. Thank you, Madam Chair.

I am looking forward to hearing from the panelists that are going to be testifying today. Although we have made some progress since the attacks of September 11, obviously the fight is not over. Al Qaida continues to pose a great threat to this country's national security and Congress has a responsibility to take action and protect our citizens from the threat of terrorism.

It is the job of this subcommittee, under your leadership, Madam Chair and Ranking Member Gutierrez, and the responsibility of all members of Congress, regardless of which side of the aisle that we sit on, to destroy the mechanisms of terrorist financing. We must take every necessary step to uproot the sources of funding for terrorist activity, while at the same time making sure that we protect the free flow of capital for legitimate commercial purposes. I think that is the balance that is going to be important for this committee to eventually strike.

I look forward to hearing from today's panelists and will work with my colleagues on the subcommittee to address this grave problem. Thank you.

I yield back the balance of my time.

Chairman KELLY. Thank you.

Mr. Price, I understand you do not have an opening statement. Is that correct?

Mr. PRICE. I appreciate the opportunity and look forward to the testimony.

Chairman KELLY. Thank you.

With that, with us today here on the first panel is Assistant Secretary of the Treasury for Terrorist Finance Juan Zarate. Prior to working at the Department of Treasury, Mr. Zarate served as a prosecutor in the Department of Justice's Terrorism and Violent Crime Section. In that role, he helped to investigate and prosecute several terrorism-related cases, including the USS Cole investigation. While at the Department of Justice, he also specialized in cases relating to weapons of mass destruction and prosecuted firearms-related cases in the District of Maryland, as well as serving a short term as an attorney in the Appellate Section of the Criminal Division.

Mr. Zarate, you come to this job with a tremendously strong background. We welcome you and we welcome you here on our panel. You may proceed.

STATEMENT OF HON. JUAN C. ZARATE, ASSISTANT SECRETARY FOR TERRORIST FINANCING, DEPARTMENT OF THE TREASURY

Mr. ZARATE. Chairman Kelly, thank you very much for the very warm introduction. Ranking Member Gutierrez, I want to thank you very much for your warm thoughts in the conversation we had before. I will be looking to your example and others on this committee as to how to be a good parent, so I really appreciate the thought.

Chairman Kelly, Ranking Member Gutierrez and distinguished members of the subcommittee, thank you very much for this opportunity to talk to you today about the abuse by terrorists of informal means of financing and the U.S. government's efforts to combat those efforts. This is an important and complex issue, and I again applaud the subcommittee for its continued focus on the changing face of terrorist financing.

The Treasury Department particularly appreciates the leadership of you, Madam Chair, as well as the subcommittee, and your support in terms of the Office of Terrorism and Financial Intelligence. We thank you very much.

The axiom now accepted around the world is that we must concentrate our national and collective power on breaking the financial ties that bind terrorist networks. Since September 11, we have focused on financially isolating those who support terrorism, while at the same time building systems and capacities in the international financial system to heighten the risks and costs associated with moving tainted capital. Throughout this period, U.S. leadership has helped foster a growing realization internationally that securing the financial systems and all vulnerable sectors, in addition to targeting the sources of terrorist support, is an essential element of our fight against terrorism and financial crimes.

Through an unprecedented global effort to attack terrorist financing, it is now harder, costlier and riskier for terrorists to raise and move money around the world. Terrorist assets and conduits of funding have been frozen, shut down or otherwise neutralized. Key facilitators have been captured or killed. Otherwise sympathetic

donors have been deterred or isolated, and through training and technical assistance, we have increased the capacity of our global partners to combat terrorist financing.

In addition to concentrating on the formal mechanisms used by terrorists and criminals to hide sources and eventual uses of money, we have addressed the various informal ways that are vulnerable to terrorist abuse. In this realm, we know that terrorist groups of all stripes use a variety of mechanisms to raise and move money. Al Qaida has relied on the corruption of charities and deep-pocket donors for financial support. Hamas holds fundraising events.

The terrorist cell that launched the devastating attacks on Madrid's train system raised money through drug dealing. Colombia's notorious FARC, ELN and AUC narco-terrorists maintained drug cartels and kidnapping operations in order to support their terrorist operations. Still others like Hezbollah, ETA and Jemaah Islamiyah employ front companies and phony businesses to funnel cash or extortion taxes meant to subsidize their networks. In addition, as Al Qaida balkanizes, the organizations and those localized cells that are aligned with it are relying on additional sources of financing to survive and proliferate.

We have applied a consistent approach to these evolving challenges. This has involved confronting the relevant systemic risks attendant to different sectors of the international financial system, both formal and informal. This is done in order to bring greater transparency and accountability to financial transactions globally. To this end, we have supported and encouraged the worldwide expansion of regulatory oversight to previously unregulated sectors, garnered more information from the newly regulated communities, and applied enforcement pressure when and where needed to help ensure compliance. In many respects, these efforts have shown the light of day on previously unseen or untended corners of the financial world.

In my written testimony, I lay out for the subcommittee in some detail the various informal or non-bank mechanisms that we think are vulnerable to terrorist abuse, as well as steps that we have taken to address the attendant risks. It bears mentioning that we have applied our resources in a manner that is consistent with the level of risk we ascribe to the vulnerable systems. With respect to charities, our strategy has combined designations and concentrated enforcement actions with greater oversight efforts, heightened international standards, and private sector awareness. With respect to previously unregulated sectors like hawalas, we have started the process of building awareness in the financial community, as well as in a new regulatory system both domestically and internationally, that has catered to these less formal sectors. Combined with targeted enforcement actions, these efforts are taking effect, but there is much more to do to ensure that this sector is fully identified and is operating legitimately and with full transparency.

Given increasing reliance on cash couriers by Al Qaida, we have launched an international response starting with the adoption of a new special recommendation by the Financial Action Task Force last year, which has resulted in jurisdictions like Hong Kong passing new laws and instituting new reporting and search practices at

their borders. In addition, we are looking at innovative strategies of melding certain types of financial data available to us to try to pinpoint couriers moving in and out of the United States.

In the case of vulnerabilities attendant to the trade in precious commodities, we have applied a similar approach, but have also used the international outrage and response to the conflict diamond issue as a means of bringing some degree of transparency and accountability to the sector. Through the Kimberley process, as well as the application of targeted sanctions on Charles Taylor and the former elements of his regime in Liberia, we are applying other tools to bring accountability to the use of precious stones from conflict regions.

We must continue to build upon this broader strategy to reduce the risks associated with the movement of money in the less formal sectors of the international financial system. With this in mind, we are looking to other financial sectors around the world that could be used not only to skirt financial regulations, but also to facilitate criminal activity and possibly terrorism. In this regard, we are working with our partners in the interagency to take a closer look at the vulnerabilities attendant to trade-based systems around the world.

Madam Chair, there is no doubt that Al Qaida and like-minded terrorist groups and their supporters will constantly search for the weak link in the preventive systems that we have put in place in the U.S. and around the world. It was bin Laden himself who indicated that Al Qaida well understood the cracks in our financial system that could be exploited. Thus, we are challenged to innovate ways of securing international financial systems and disrupting terrorist financing, without doing damage to the workings of the free market. This is part of our challenge, but we also see this as an opportunity to disrupt the financing that fuels terror, while securing the international financial system against the corruption of tainted capital.

Madam Chair, we appreciate the subcommittee's continued support and concentration on these issues. We look forward to continuing to work with you on all of these evolving issues.

Thank you.

[The prepared statement of Hon. Juan Zarate can be found on page 59 in the appendix.]

Chairman KELLY. Thank you, Mr. Zarate.

Other witnesses are going to testify about the unique monetary and cultural role that gold plays in Saudi Arabia. Without an FIU in place, it seems that our efforts to effectively track and understand the flow of gold and other commodities there are lacking a critically important tool. Of course, there are other obvious benefits to having an operational FIU in Saudi Arabia. When I asked about the status of the Saudi FIU in August of 2004, Assistant Secretary Levey said, "It has not happened yet." As you know, he said this almost 2 years after the Saudi government had declared that they had established an FIU. He went on to talk about the Saudis, and I am quoting again from the record, "There are lots of areas in which they have made significant progress, progress that is very valuable to us, but there are also situations where they need to move further and we need to continue to push them."

The FIU situation is one of them. Another is that while they announced the regime to monitor charities in the kingdom, it does not cover certain organizations that we have long thought have terrorist financing concerns. You and I have had subsequent conversations about this in the September hearing, and I know that together we share a strong desire to continually improve the value of the important alliance that we have with Saudi Arabia in this horrible fight against terrorism, but Under Secretary Levey's comments resonated with many of us who really want to strengthen that U.S.-Saudi partnership.

My question is whether or not you are optimistic that we can continue to make substantive progress in making sure that Saudi Arabia is an effective partner in combating the terror financing that unfortunately flows from their country.

Mr. ZARATE. Madam Chair, I am optimistic. I think the relationship with Saudi Arabia in the context of terror financing is essential. As you have mentioned, sources within Saudi Arabia as well as other sources in the Gulf have proven to be sources for Al Qaida and other like-minded terrorist groups. So it is essential, and this is why we have devoted so much attention to this issue. It is essential that we have in place mechanisms with the Saudis to not only share information, but to ensure that the Saudis themselves can take control over these issues.

I think what is most encouraging, Madam Chair, is that in particular after the bombings in Riyadh, the Saudis have taken very seriously the threats attendant to their own regime, based on the threats of Al Qaida and other groups. They recently hosted the worldwide counterterrorism conference attended by Homeland Security Adviser Fran Townsend and a member of my office, and a high-level delegations from the U.S. government. The Saudis are taking this issue very seriously, but I will reiterate what Under Secretary Levey has said, which is there are a range of issues that we continue to push the Saudis on, some of which you have identified. It is essential that we continue to do so, and continue to work with them.

Chairman KELLY. Do you think we are going to be able to ensure that there is a more rigorous approach to the designated individuals in Saudi Arabia?

Mr. ZARATE. Madam Chair, I believe so. I think one of the highlights of our engagement with the Saudis has been a more progressive willingness on the Saudis' part to take preventive administrative actions to freeze assets. That has been part of the cornerstone of our international efforts to staunch the flow of funds to terrorist groups. It has been a number of joint designations with the Saudis that has proven in large respects their willingness and their seriousness with respect to applying those types of measures.

But I think what we need to continue to do is to work with them on identifying known conduits, known sources of funding, and working with them to isolate those individuals. We did so in December with an individual by the name of Adil Batterjee. We have done so previously with individuals like Yasin al Qadi and Mr. Julaiden. We have certainly done so with the case of Al Haramain and the threat that that charity posed worldwide. I am hopeful that those actions will continue not only because they are impor-

tant to us, but I think the Saudis now realize they are important for their own safety.

Chairman KELLY. And you feel that the Saudis are actually following up once we do this designation and discussion with them, they are actually going to do something about these things. The list you just gave, for instance, have they done anything to freeze assets or stop the individuals, especially Al Haramain? What have they done? Do you know anything about these?

Mr. ZARATE. Madam Chair, based on the information I have, and I was last in Riyadh in November talking about a number of these issues, some of the issues that you raised earlier. Based on the information I have, they have certainly taken actions to freeze the assets of those individuals, in particular the Al Haramain charity which presented numerous legal complications for them, given the extent of the reach of that organization within the kingdom, as well as internationally.

So I am confident that they are taking actions, but I have to be honest with you, Madam Chair, we are constantly working with the Saudis to ensure that that is the case. One of the issues that we have talked to them about is ensuring that we have a complete record of the assets that have been frozen since September 11.

Chairman KELLY. And they are cooperating, I hope.

I am out of time here.

Mr. Gutierrez?

Mr. GUTIERREZ. Thank you, Madam Chair.

I would like to start by asking you about your Under Secretary is proposing to transfer in 2006 the 23 people from the terrorist assets division of OFAC to the departmental offices. What is your view on this change? Weren't there a minimum number of employees statutorily established for OFAC of employees and people, and wouldn't this violate that floor of employees?

Mr. ZARATE. Congressman, with respect to the OFAC floor, which I believe you are referring to, I think the floor is 120 FTEs, if I am not mistaken, but we can verify that for you. I think this transfer, with the infusion of additional FTEs for other functions under OFAC keeps us above the OFAC floor. So we have been working very closely with members of Congress as well as the budget and management folks to ensure that we are in complete compliance with those strictures.

On the broader issue with respect to the transfer of the 23 employees who were part of the Foreign Terrorist Division within OFAC, this is, in my opinion, a necessary and natural evolution of how the Treasury is going to be working on these issues. One of the key and important elements of the new Office of Terrorism and Financial Intelligence was the establishment of a robust and very real office of intelligence and analysis. At the heart of what that office will do will in essence be a good bit of the analytical work with respect to terrorist financing, with respect to the movement of illicit flows of funds, with respect to money laundering, which has been done in large part within the structure within OFAC.

So what this is, is a rationalization of the process and a bringing into Treasury proper resources and the know-how and the human capital to be able to deal in the long term with the broader issues

that we are talking about. That is in addition to new hires that we are bringing on in terms of our analytical capabilities.

Mr. GUTIERREZ. So we are going to move them to the intelligence part of Treasury. I know you are not the Under Secretary, but as we move 23 people, don't you think we should have the Assistant Secretary for Intelligence in place, instead of having a career professional who is probably doing a great job but it is a career professional in a vacant position. We do not have an Assistant Secretary for Intelligence, but we are moving people into a division where we have it. Can you tell us where we are at on that issue, if you know?

Mr. ZARATE. Congressman, first of all, I think that the movement of personnel is very important in terms of the holistic functioning of this office. I think, even though there is not an Assistant Secretary in place, it is important to make this move now and to make it quickly, to do it quickly and efficiently. I will tell you that the Deputy Assistant Secretary Janice Gardner, who is operating the Office of Intelligence Analysis, is not only a committed career employee, but she is a true professional through and through and doing an enormous job for the U.S. government and for the Treasury. With Under Secretary Levey's leadership, I do not see there being a problem.

With respect to getting a person in place, I know that the White House continues to work on that and it is a top priority.

Mr. GUTIERREZ. In my humble opinion, I am thankful for professionals and I am sure she is doing a great job, but it just seems to me that somebody who is, I mean, I look at you and your role and the development that you have had as Assistant Secretary. I say to myself, we need a person who sees this as their focus, their job, much as you have seen this as your focus, your job, in terms of developing leadership. You know how it works. The person is not going to be there maybe next month. Who knows what happens in the chain of command with people, and how you have priorities and a vision and you take that to the Under Secretary and then to the Secretary of Treasury to make sure that those patterns get carried out.

I am going to have, because of the constraints of time, I am going to have a few questions that I am going to hand to you in writing. I am just going to ask you two more. Given the fact, you know, this lack of a Secretary here, and your involvement, does OFAC report to you now?

Mr. ZARATE. Based on the legislation coming out of the intelligence bill, OFAC reports to the Under Secretary. That authority can be delegated to me. The way this has operated, after the Homeland Security transition, OFAC did in fact report to me in my previous capacity as Deputy Assistant Secretary for Terrorist Financing and Financial Crimes. We have been operating for the last year-and-a-half with that construct, where OFAC reports up to me.

Mr. GUTIERREZ. Okay. And it continues to report to you to this day under the authority of the Under Secretary to be able to delegate it to you?

Mr. ZARATE. That authority has not been technically delegated, to my knowledge, but the organization within TFI is fairly fluid, so we all work together very closely.

Mr. GUTIERREZ. Because when I read section C, it says the Office of Foreign Assets Control, in this section referred to as OFAC, which shall report directly to the Under Secretary for Terrorism and Financial Crimes. I am just wondering if they are reporting to you, how that delegation of reporting to you, how would I say, blends with the statute as I read it. Do you see any contradiction between the statute and the fact that OFAC reports to you?

Mr. ZARATE. Well, again, as I said, technically OFAC reports to the Under Secretary. In past form and function, they have reported to me, given the Treasury orders and organization charts. There is not really a problem in the sense that we read and our lawyers read the legislation, to allow for the delegation of that authority down to me. As I indicated, I would have to check with our Treasury lawyers, I do not think that that authority has yet been delegated officially to me.

Mr. GUTIERREZ. Does FinCEN report to you?

Mr. ZARATE. FinCEN, based on the bill, now reports to the Under Secretary. The way that we read the language, that authority cannot be delegated based on what the legislation says.

Mr. GUTIERREZ. So when it comes, and I will finish now, Madam Chairwoman, so as Treasury see it, OFAC, as your lawyers and your people read it, the Under Secretary can delegate that to someone else, but not FinCEN, so FinCEN does not report to you.

I will hand over the rest of the questions in writing. Thank you very much.

Mr. ZARATE. Thank you, Congressman.

Chairman KELLY. Thank you.

Mr. Fitzpatrick?

Mr. FITZPATRICK. I want to say thank you for your testimony today and also for your service to our nation as a prosecutor and now at the Department of Treasury. I appreciate that.

I was wondering if you could talk to us about whether you have seen or are aware of any credible evidence that Al Qaida is operating the conflict diamond sector in Africa.

Mr. ZARATE. Congressman, that is a very good question. Let me take this opportunity to compliment one of the next panelists, Doug Farah, who has done incredibly important reporting on these issues and has been intrepid in the work that he has done. I admire him greatly. I wanted just to mention that because he has in large part been a driver in the public sphere on this issue.

With respect to the connection, I leave that specific question to my FBI and intelligence colleagues. The FBI has sent a couple of teams out to West Africa to investigate ties. I will tell you, from my experience we have not seen direct links. We looked at this issue early on, even as the first article from Mr. Farah was coming out in November, 2001. I have met with Belgian authorities. We have had Treasury officials meet with the Diamond Council around the world. There is no direct evidence that we see that ties Al Qaida.

That being said, the trade in precious commodities, in particular conflict diamonds, is an area rife with potential corruption. As Congressman Scott, I believe, indicated, it is these untended corners of the world where there is opportunity for great mischief. We have seen that with Charles Taylor and what he did in Liberia. We have

seen what that produced in terms of not just fomenting of rebellion in Sierra Leone with the RUF, but also with arms trafficking and other nefarious behavior.

So even if there is not a direct link to Al Qaida, it is an issue of concern to us because it presents a gap or an opening for criminals and rogue leaders to take advantage.

Mr. FITZPATRICK. Does your department have the ability to control directly or indirectly through regulation or otherwise that kind of trade?

Mr. ZARATE. We are certainly part of it. By "we," I mean the greater U.S. government, part of the Kimberley Process, which is the first attempt to apply a certification regime to the diamond trade, which I think is a good first step. It certainly is not the silver bullet for this issue, but it is a good first step. We domestically, the Treasury Department that is, have the ability to regulate dealers in precious stones and commodities. We have put out an interim rule, a proposed rule about 3 years ago now. We are in the final stages of coming out with a final rule, so we do have the ability internally to control to a certain extent the trade and dealing in precious stones.

The other element of this, and I think you alluded to this, Congressman, very aptly in your opening remarks, part of this is creating mechanisms where we can share information more fluidly. Part of that is doing so in the Egmont Group, making that a more strategic information-sharing body. That is one of my priorities. That is one of Bill Fox's priorities as director of FinCEN. Another issues, as I referred to in my testimony, is looking at sharing data with respect to trade anomalies and trade transactions in a much more robust way.

So there are different ways of getting at this, even if we do not have jurisdiction to reach into West Africa or reach into Southwest Africa or reach into different parts of the world that are proving problematic.

Mr. FITZPATRICK. I yield back my time. Thank you.

Chairman KELLY. Thank you.

Mr. Scott?

Mr. SCOTT. Thank you very much, Madam Chairman.

Assistant Secretary Zarate, it seems to me that while seizing the asset is very important, it seems to me that much more important is maybe backing off of that and being able to watch and follow the flow of that money trail as a really more effective way of that. And that requires, of course, using intelligence. It concerns me that in the department the position of Assistant Secretary for Intelligence is not filled and has not been filled.

So that is a gaping hole in dealing with perhaps the most fundamental area and really putting a dent in terrorist financing if we do not even have the position filled in the Treasury Department of the very person who is charge of gathering intelligence. This is devastating not only in terms of our not being able to follow the money trail, but really in getting to the issue of understanding the depth of these nations and these countries who are providing safe havens. How could the Treasury Department allow this most crucial position of Assistant Secretary of the Treasury for Intelligence to go unfilled? What is it doing to hamper our progress?

Mr. ZARATE. Congressman, you raise a serious issue. Again, I reiterate the fact that the White House has it as a priority. Certainly, Secretary Snow understands the seriousness of this and we are moving as quickly as possible to fill that position. That being said, Congressman, I will tell you that the lack of having someone in that position is not hampering our effectiveness with the intelligence community at large and our ability to balance the tradeoffs that you are talking about, the tradeoffs between taking action now based on information and intelligence we have, versus waiting and watching and allowing for a longer-term approach in terms of following the money trail.

That is something, frankly, that we have been doing since September 11 very closely with the intelligence community. That is part of the reason we have had a very effective policy coordinating committee that has done precisely what you indicate, which is a balancing of that tradeoff. In a post-9/11 world where you have terrorist groups not only intent on killing us, but perhaps doing so with apocalyptic force, it becomes a very important debate as to whether or not we take actions to prevent certain elements of support and activity, versus waiting and watching. That goes to the heart of how we function.

Mr. SCOTT. It has been 2 years. I mean, I am trying to figure, is there any reason why this has not been done?

Chairman KELLY. If the gentleman will yield, the Chair would remind members that nominations and confirmations are not within the constitutional authority of the House. The questions are appropriate, but this is not a constitutional authority that we have in the House of Representatives.

Mr. SCOTT. I realize that, Madam Chairlady, and I certainly respect that, but I do think that the American people are certainly owed an understanding as to why this very vital position of intelligence continues to go unmanned.

Let me go to another point. We have dealers in precious metals, in stones and jewels, that are included among the many types of financial institutions defined under the Bank Secrecy Act. Yet the Treasury Department has not issued a regulation pursuant to section 352 of the PATRIOT Act requiring diamond dealers to establish anti-money laundering programs. Let me ask you this question, if I can get an answer to this one: When will Treasury propose a rule to address this provision of the PATRIOT Act?

Mr. ZARATE. Congressman, as I indicated earlier, it was 2 years ago that we laid out the proposed rule, which does in fact create obligations on dealers in precious stones. What we have is an ongoing process which I think and hope will be finalized very soon when we put out the final rule with respect to this important sector. What I will mention is that this is part of the grand expansion of the Bank Secrecy Act, post-9/11. Heretofore, there has not been federal regulation of this sector, which I will remind this committee, leads very easily into the retail sector and the complications attendant to that and the potential economic outflow from the regulations we come out with are serious and severe.

So we have been working at this diligently, trying to get as much information as possible. As I indicated, this was not a sector that we had previously regulated, so a lot of this was writing on a blank

slate, but I am hopeful that we will very shortly have a final rule that helps explicate what the obligations finally are.

Mr. SCOTT. Finally, let me just ask you this question.

Chairman KELLY. I am sorry, but you are out of time.

Mr. SCOTT. That is fine. Thank you.

Chairman KELLY. We come now to Ms. Moore.

Ms. MOORE OF WISCONSIN. Thank you, Madam Chair, for this opportunity.

I also was interested in sort of the administrative work that is needed to be done to combat terrorism. My question really relates to what the timing is in issuing guidelines for handling MSBs. You stated in your opening comments that the hawalas are a primary source of criminal movement of money.

At the same time, this is a primary resource for many folks in urban areas who have no checking accounts, and many other poor people. I recall in my own lifetime that money orders were primarily the ways and means that my family could best do business. And there are many financial institutions that are deciding to pull out of these instruments because of the perceived regulatory problems and no guidelines really being issued.

So I am concerned about the timetable for putting that in place, so that we can effectively track terrorist activity, but not hamper the ability of poor people to conduct business.

Mr. ZARATE. Congresswoman, you raise an incredibly important issue, and it goes to the heart of our function, which is to balance the regulatory burden placed on the financial community with the benefits associated with those regulatory burdens.

What we have done, and what I said in my written testimony, and I hope this is reflected well, is that hawalas certainly, and money service businesses writ large, are essential elements in many cases to the economy. MSBs, as they are referred to, form an essential part of remittances to the developing world, and it has been a consistent U.S. government and Treasury policy to ensure that we are encouraging those types of flows of money. That, I think, is an essential point.

With respect to guidance on this issue, I think this is very important. This is something that Secretary Snow addressed publicly before the Florida Bankers Association. I did as well. What we are planning on doing is having an MSB conference in the context of the Bank Secrecy Act Advisory Group, to in part talk about not just the regulatory and enforcement challenges which we have, which are real and which I indicated in my testimony, but also to deal with the economic impact and the regulatory response that we are seeing from the private sector.

Part of the outflow from that I hope will be joint guidance from the Treasury and the regulatory body with respect to what is expected and anticipated of the financial community when dealing with money service businesses.

We did something similar in the context of embassy banking after the Riggs enforcement actions led to some confusion with respect to how to deal with embassy bank accounts. I see something similar here in this case.

Ms. MOORE OF WISCONSIN. Thank you.

Chairman KELLY. Mr. Cleaver?

Mr. CLEAVER. Thank you, Madam Chairperson.

Mr. Secretary, is there a delegation in Saudi Arabia at this time from Treasury?

Mr. ZARATE. We had a delegation as part of the Fran Townsend delegation that was attending the Saudi counterterrorism conference. We do have on a permanent basis a working relationship. This is an important point and we have made this point before, an important working relationship with Saudi security forces internally in a Joint Terrorist Financing Task Force, which has been an important element of our information sharing and an evolution of how it is that the Saudis work at these issues.

Three years ago, the Saudis, and this goes, Madam Chair, to some of your questions, 3 years ago the Saudis did not necessarily look at financing the way that we do. They did not, when conducting searches, pick up receipts and look for financial records. We have engaged in intense training with them, intense collaboration. What we have on the ground now, led by the FBI, is a Joint Terrorist Financing Task Force which is proving valuable.

Mr. CLEAVER. Is it possible that you could provide the committee with a list of the individuals in that delegation from Treasury and their titles, and the roles that they are playing while there?

Mr. ZARATE. Certainly, Congressman, we can provide both the names of the delegation that attended the conference with Ms. Townsend. We could also in consultation with the NSC, obviously, and then we can certainly provide names as appropriate as to who is on the ground. There may be some sensitivity to that, given the security relationship, and to a certain extent we will have to go back and talk to the FBI about that, but I will try my best and we will take that back.

Mr. CLEAVER. Thank you.

Thank you, Madam Chair.

Chairman KELLY. Thank you, Mr. Cleaver.

Mr. Moore?

Mr. MOORE OF KANSAS. Thank you, Madam Chair.

Again, Mr. Zarate, I appreciate your being here. I want to follow up on a question that Ms. Moore asked you and that you answered, and this may partially already answer my question, but I just want to refine it a little bit.

As you know, MSBs play an important role in many urban communities. These small community-based businesses, in partnership with the banks or other financial institutions, provide necessary money transfers to many neighborhoods with significant immigrant populations. Often, at times community members will feel more comfortable with the local MSB than they might with a large national bank that does not have a presence in their community.

Certain regulatory requirements contained in the PATRIOT Act are causing some banks to sever their relationships with MSBs, is my understanding, because these banks have a business relationship that unless conducted separately require a review of MSB policies. In fact, this is including their anti-money laundering policies, their financial information third party references, information on owners and other business information. These relatively new reporting requirements have apparently caused some banks to believe they should not carry on these relationships with MSBs be-

cause of the increased regulatory burden associated with doing that.

I think we all, I think everybody on this committee and probably every member of Congress feels we must do all we can to protect our country and our people from money laundering that is associated with financing terrorist organizations in this post-9/11 world. I think we all agree that is a reasonable thing that must be done in a reasonable manner.

You have already kind of answered this question, but do you agree that MSBs can play a useful role in our cities? And what steps can Treasury Department take to alleviate the problems they are facing? You indicated that there might be an MSB conference coming up. Is there a timeframe for that and where and when might that be? If you can tell me if you have that information, we would like to get information from that to see if this issue, if it is an issue and a problem, can be addressed in an administrative fashion, or does it need to be addressed by Congress for further action?

Thank you.

Mr. ZARATE. Thank you, Congressman.

Again, you and Congresswoman Moore raise very good and important issues. These are issues that we hear as well, and I know you hear it from various banking associations and proprietors. This is a serious issue because money service businesses form part of the financial sector that is important. It is important to rural communities, to ethnic communities, to less-served communities. Access to the financial system by individuals is incredibly important and it is a part of Treasury's mission, frankly. So that is important.

What I think we are seeing, sir, is part of the growing pains of the post-9/11 expansion and deepening of the anti-money laundering system. You have sectors, as I mentioned in my testimony, that have previously been unregulated, at least federally, and an attempt to try to mesh the federal system with ongoing practices, as well as with the more formal sectors that are well regulated and know how the system works.

Part of our challenge, and again I think this is what the MSB conference will in part focus on, will be finding the right balance of expectations. What is expected of the formal financial sector? What is expected of the MSB sector? I think the conference will go a long way. Our intent is to have that fairly soon, sir. I would hope sometime in the next three to four weeks, as soon as we can schedule it with the appropriate parties.

Chairman KELLY. Thank you, Mr. Moore.

Ms. Wasserman Schultz?

Ms. WASSERMAN SCHULTZ. Thank you, Madam Chair.

Mr. Zarate, I am from the state of Florida. You might be familiar with the case of Sami Al-Arian in Florida and the fact that it took approximately 7 years, if not longer, to bring indictments against Mr. Al-Arian. He was a full tenured professor at the University of South Florida, operating an Islamic academic institute on the campus, was here legally in the country, and ultimately was accused of and is now in jail for operating a terrorist financing network. In fact, one of his lieutenants actually went back to the Middle East to head Islamic Jihad. So obviously not a very good guy.

One of the concerns that I have, and I would just like you to respond to it, is that there is a balance that I referred to in my opening statement about balancing how we interact with commercial financial institutions and suspicious activity reports, needs to be struck carefully. On the one hand, it took almost 7 years to bring indictments against Mr. Al-Arian, but you can actually potentially drive this activity underground if you are overly aggressive in pursuing this, because they will just find another way to interact and pursue their financial transactions.

So as it relates to that kind of activity, how are you striking that balance?

Mr. ZARATE. Congresswoman, again, you hit a very good point. It is a consistent message that we have stated both domestically and internationally. Frankly, we have done so very forcefully internationally. The idea that bringing, and this is reflected in my testimony, the strategy is bringing these previously unregulated sectors into the light of the regulated community so that there is greater transparency, there is greater accountability, so that we have access to information that we did not have access to before, and to deal with it in as open and transparent a way as possible.

So part of it is developing international standards, which we have done which reiterate that very point. The United Arab Emirates has hosted a number of hawala conferences. They are going to have their third conference here in April where that theme is reiterated over and over again, because the last thing we want is for providers of financial services to be driven underground.

You are right. There is a potential here in the MSB context for certain money service businesses, hawalas or otherwise, to be driven underground either because of regulatory burdens or because they are not being serviced by the formal financial sector.

So that is precisely what we are trying to avoid, and it is a common message that we have with banking associations, with the general public, and will be a major theme of this conference which I think will be an important step in setting forth expectations.

Ms. WASSERMAN SCHULTZ. How are you trying to, if you could be more specific, how in the future are we going to ensure that it does not take almost a decade to prosecute and discover the activities of someone like Sami Al-Arian?

Mr. ZARATE. Congresswoman, I cannot speak, although I was formerly part of DOJ, I cannot speak for DOJ and that prosecution in particular. I will tell you that those types of cases and terrorist financing and support and material support cases are very difficult to make. We have prosecutors on the frontlines of this every day who are doing yeoman's work and phenomenal work to make these cases, but I think it bears mentioning that prosecutions are, as we say often with designations, one tool in our tool shed to bring to this issue.

And quite frankly, we have been preaching since 9/11 the importance of the preventive aspects of the designation. Designations and the freezing of assets are a way of using our administrative authorities and the President's executive powers to preventively arrest assets, not individuals, but arresting assets in a preventive way and in a way that does not tie us into the criminal legal process.

So I think there is a larger point in what you are indicating in that it is very difficult to often draw the clear ties between someone who is engaging in support activities generally to terrorism more specifically. Our prosecutors are doing great work around the country to do just that, but it is difficult work.

Ms. WASSERMAN SCHULTZ. In light of your comments, then, the ones you are just making now, what relevant portions of the PATRIOT Act, since this administration has continued to point to the PATRIOT Act as being evidence of the positive steps we have taken to prevent cases like Sami Al-Arian, what relevant portions of the PATRIOT Act are going to help ensure that that type of activity is discovered more quickly and caught?

Mr. ZARATE. Congresswoman, again I cannot speak to all the various titles of the PATRIOT Act. I am more expert on Title III, which is relevant to the subject that we are talking about here. I will tell you that given my past experience at DOJ and given the changes provided and tools provided in the PATRIOT Act in terms of allowing the flow of information to flow between government agencies in a much more robust way, allows for these types of cases to theoretically be brought to fruition much sooner.

In the Title III context, we have the ability now, and this was an innovation from Congress and a very good one, the ability to share more information with the financial community and frankly to provide safe harbors to the financial community to share information with each other. That is very important because as we see trends, we see customers trying to move from one financial sector to another or one institution to another, it is important for these financial institutions to speak to each other.

Just 2 weeks ago, FinCEN announced the establishment of the 314(a) secure network, which allows for the passing of more secure information to the financial community, which is something that they have been hungry for, something that we have wanted to do, and build on the 314 process which is in the PATRIOT Act, which has allowed us to get leads and information out to the financial community and to get information back.

So all of that, the theme of greater information sharing, greater flows of information both vertically and horizontally I think is the key element of the PATRIOT Act and why it is so important.

Let me just say, one other element of the PATRIOT Act that we have found incredibly important from a diplomatic and strategic standpoint. Madam Chair, you talked about the certification process. One of the tools you all provided us was Section 311 of the PATRIOT Act, which gives the Secretary of the Treasury the power to identify foreign jurisdictions, foreign entities or classes of transactions as a primary money laundering concern. We have used that now eight times. We are using it strategically. It is part of the national security thinking now, and that is incredibly important.

Chairman KELLY. Thank you very much, Ms. Wasserman Schultz.

Ms. WASSERMAN SCHULTZ. Has my time expired?

Chairman KELLY. Yes. The red light up there indicates it. When the green light is on, you have 5 minutes. When the yellow light is on, you have 1 minute to sum up. And when the red light goes, you are out of time.

Ms. WASSERMAN SCHULTZ. Thank you.

Chairman KELLY. Thank you.

Mr. Zarate, during your testimony you spoke about goods. Beyond precious gems, a lot of physical goods are moved through international trading systems legitimately every day. The system can also be abused by terrorists and I am concerned about whether or not the Treasury is worried about this, or focused on this. I would like to know your thoughts about what the vulnerabilities are there.

Mr. ZARATE. Madam Chair, I think the trade-based vulnerabilities are real, and we are very concerned about it. I present in the written testimony a discussion of the black market peso exchange process, which is in essence a trade-based value transfer system that has been used over the past couple of decades in South America to help launder money. It has been a primary way for the Colombian cartels, for example, to launder their funds by the use of trade transactions with the Caribbean and with the United States.

So we are very concerned about it. We have addressed it in concrete ways in the black market peso exchange context, but we are also concerned as to how it relates to evolving free trade zones around the world, as well as with respect to trade anomalies, in particular with rogue regimes. So that is an important element of what we are starting to look at.

Chairman KELLY. Thank you very much.

The Chair notes that some members may have additional questions for this panel that they may wish to submit in writing. So without objection, the hearing record is going to remain open for 30 days for members to submit written questions to the witness and to place the responses in the record.

Mr. Zarate, we wish you very good luck with the birth of your child and we thank you so much for spending time with us here this morning.

This panel is dismissed.

Mr. ZARATE. Thank you, Madam Chair.

Chairman KELLY. While the next panel is being seated, I would like to introduce our next panel.

It consists of Mr. Mallory Factor, who is the President of Mallory Factor, Incorporated. He is a member of the Council of Foreign Relations Task Force on Terror Finance, and he is a New York State banking regulator.

Our second witness is Mr. Douglas Farah, a former investigative reporter in West Africa. He is a frequent writer on terrorist finance and the author of a book, Blood for Stones.

Gentlemen, any time you are ready, if you would give me that indication we will go forward. Is the panel indicating that they are ready?

We begin with you, Mr. Factor.

STATEMENT OF MALLORY FACTOR, PRESIDENT, MALLORY FACTOR INC.

Mr. FACTOR. Chairwoman Kelly, Congressman Gutierrez and distinguished members of the Subcommittee on Oversight and Investigations, thank you for inviting me to testify today.

Chairwoman Kelly, I would like to commend you in particular for addressing head-on the complex issue of terror financing through your introduction in the 108th Congress last September of a tariff financing certification regime, and your commitment which continues on this issue. Thank you very much for your leadership.

My remarks are informed by two reports of an independent Task Force on Terrorist Financing on which I served as Vice-Chair and which was sponsored by the Council on Foreign Relations. I am testifying in my personal capacity, as is customary, and not on behalf of the task force or the Council on Foreign Relations. In my written testimony, I set forth seven forward-looking recommendations for Congress to improve U.S. efforts against terrorism financing, three of which I will discuss briefly today. I welcome your questions, however, on any of these recommendations.

First, Congress should enact a Treasury-led certification regime specifically on terrorist financing. A certification regime should require the Treasury Department to provide a written certification on an annual basis, classified in whole or in part if necessary, detailing the steps each foreign nation has taken to cooperate in U.S. and international efforts to combat terror financing. To be truly meaningful, a certification regime must focus first on the nation's laws and regulations against terror financing and second, on the extent to which the nation actually implements these laws and regulations to combat terror financing.

The certification regime should provide for sanctions under Section 311 of the PATRIOT Act on nations that do not receive certification. These sanctions would include denial of U.S. foreign assistance monies and limitations on access to the U.S. financial system. Of course, sanctions would be subject to waiver by the President if required by vital U.S. national interests.

A certification regime for terror financing would ensure that the special measures provided by Section 311 of the PATRIOT Act are used appropriately and thoughtfully against rogue jurisdictions. Although the PATRIOT Act gives the Administration powerful tools against terror financing, my understanding is that the Administration has used its Section 311 powers only once in the context of terror financing. A separate certification regime for terror financing ensures that stringent requirements are maintained and revisited annually with respect to each nation's practices on terror financing.

U.S. News and World Report reported that the State Department appears unenthusiastic about a terror financing certification regime "because it could end up citing allies like Indonesia, Nigeria and the Philippines." This objection precisely highlights the need for a certification regime. The Executive Branch needs to formally review the progress of each nation on terror financing annually without regard to whether such a nation is a so-called "ally" of the United States.

Second, the U.S. government should increase sharing of information with the financial services sector as permitted by Section 314(a) of the PATRIOT Act so that the sector can cooperate more effectively with the U.S. government in identifying terror financiers. Helping private sector financial institutions become effective partners in identifying financiers of terror should be a top priority. The procedures of Section 314(a) of the PATRIOT Act which

promote information sharing between the U.S. government and financial institutions to increase detection of terror financing are not working as well as they should. Banking industry officials tell me that the U.S. government is still not providing financial institutions with adequate information to enable the institutions to detect terror financing.

Financial institutions are used primarily to assist in investigating known or suspected terror financiers, not in identifying unknown ones. Very little information is flowing from the government to financial institutions. I recognize that the information that would enable financial institutions to become effective partners may be highly protected intelligence information. In other industries such as defense and transportation, however, persons can be designated by the U.S. government to receive access to certain high-value information as necessary. A similar approach could be used to facilitate information sharing and cooperation between the U.S. government and private financial institutions. I strongly encourage this subcommittee to hold an oversight hearing on Section 314 of the PATRIOT Act to determine how more effective procedures for information sharing with financial institutions can be developed and implemented.

Third, the National Security Council (NSC) and the White House Office of Management and Budget (OMB) should conduct a cross-cutting analysis of the budgets of all U.S. government agencies as they relate to terrorist financing. A terrorist financing cross-cut would allow policymakers to gain clarity about who is doing what, how well, and with what resources. With this information in hand, the Administration and Congress can begin to assess the efficiency of existing efforts and the adequacy of appropriations relative to the threat.

I thank you and I look forward to your questions.

[The prepared statement of Mallory Factor can be found on page 36 in the appendix.]

Chairman KELLY. Thank you, Mr. Factor.

Mr. Farah? I want to say, Mr. Farah, I read your book. I am very interested in what you have to say here today.

STATEMENT OF DOUGLAS FARAH, AUTHOR

Mr. FARAH. Thank you very much, and thank you for the invitation to be here. And thank you, Chairman Kelly, especially for your leadership in the investigation of Arab Bank and the possible support for suicide bombers in the Middle East. I think that is an incredibly important part of the terrorist financial relationship.

Commodities such as gold, diamonds and tanzanite have played a vital role in the global terrorist infrastructure. Gemstones have played a particularly important role in Al Qaida's financial architecture and has been used to raise money, launder funds, and store value. Gold, for a variety of cultural and logistical reasons, has been used primarily as a way to hold and transfer value. These commodities are not tangential to the terrorist financial structure, but a central part of it.

Diamonds have also been used extensively by Hezbollah and other terrorist groups in the Middle East that have a long tradition of access to diamonds in West Africa through the Lebanese Dias-

pora there. Gemstones are ideal for several reasons. They hold their value; they are easy to transport; they do not set off metal detectors in airports; and they can be converted back to cash when necessary. This is especially true of blood diamonds or diamonds armed by armed groups, mostly in sub-Saharan Africa in order to finance their wars.

Al Qaida sought to exploit gemstones in West Africa, East Africa and Europe almost since its inception. There is strong evidence of Al Qaida's ties to the African diamond trade, despite the reluctance of some in the U.S. intelligence community to acknowledge this link. The data comes from testimony of Al Qaida members convicted in the 1998 U.S. embassy bombings in East Africa; my own investigations into the ties in West Africa, particularly to Charles Taylor in Liberia and his allies in the Revolutionary United Front in Sierra Leone; investigations by the London-based NGO Global Witness; Belgian police investigations; and most recently, a growing body of evidence accumulated by the U.N.-backed Special Court for Sierra Leone, charged with investigating crimes against humanity in that brutal conflict.

In two reports presented to some members of Congress, the court's chief prosecutor and chief investigator, each with 30 years experience in the Department of Defense, have summarized the large volume of evidence of these ties from sources that are different from and independent of other investigations. I would be happy to provide members of the subcommittee with any of these documents.

Groups like Al Qaida and Hezbollah chose West Africa as a base because in states such as Liberia, Sierra Leone, and others in the region, governments are weak, corrupt and exercise little control over much of the national territory. Some states like Liberia under Charles Taylor were in essence functioning criminal enterprises. For the right price, Taylor let Al Qaida, Russian organized crime, Ukrainian organized crime, Balkan organized crime, Israeli organized crime and Hezbollah operate under his protection.

The evidence points to two distinct phases in Al Qaida's diamond activities. The first started sometime before 1996, when bin Laden lived in the Sudan and this was aimed at helping to finance the organization. The latter years of this activity also overlapped with the large-scale Al Qaida-dominated purchase of tanzanite in East Africa.

Wadi el Hage, bin Laden's personal secretary until he was arrested in September 1998, spent a great deal of time on gemstone deals. El Hage's file of business cards, personal telephone directory and handwritten notebooks were introduced as evidence in his trial, where he was sentenced to life in prison. The notebooks contain extensive information on buying diamonds and appraising diamonds and tanzanite. There is a page on Liberia with telephone numbers and names. His address book and business card file were full of the names of diamond dealers and jewelers, many containing the purchaser's home phone number.

It is not clear how profitable Al Qaida's gemstone ventures were. It is clear that the efforts to acquire gemstones, particularly diamonds, were frequent, widespread and a matter of priority for Al Qaida. In late 1998, following the Al Qaida attacks on the U.S. em-

bassies in Kenya and Tanzania, Al Qaida moved to the second phase of its diamond operations. The impetus was the Clinton administration's successful freezing of \$240 million in assets belonging to the Afghan Taliban government and bin Laden. The funds were mostly stored in gold reserves in the United States central banks.

The picture of Al Qaida's activities in West Africa changed dramatically in the latter half of 2000, when senior Al Qaida operatives arrived in Monrovia, Liberia. Having set up a monopoly arrangement for the purchase of diamonds through Taylor with the RUF, Al Qaida buyers went on a spree that lasted several months. But here the intention was not to make money, but rather to buy the stones as a way of transferring value from other assets. Telephone records from the middlemen handling the purchases show telephone calls to Afghanistan until September 10, 2001. The available evidence gathered by Belgian police and bank investigators points to Al Qaida purchasing some \$20 million worth of RUF diamonds during the 14 months prior to 9/11.

In the terrorist financial architecture, the use of gold is different from that of precious stones. Gold is used primarily to store value and facilitate the movement of money cross the world's financial markets. Cultural and regional factors have made gold a favorite commodity of both the Taliban and Al Qaida. In the waning days of Taliban control in Afghanistan, Sheik Omar and bin Laden sent waves of couriers carrying gold bars and bundles of dollars, the treasury of the terrorist movement, across the porous border of Afghanistan into Pakistan.

From the Afghan-Pakistan border area, the assets were consolidated and taken by couriers to Karachi, Pakistan. There, the Taliban consul general oversaw the movement of the wealth to Dubai in the UAE. The transfer to Dubai relied on couriers and the virtually untraceable informal money transfer system known as hawala. Taliban consul Kaka Zada personally acted as a courier at least once, carrying \$600,000 in a diplomatic pouch to Dubai in late November, 2001.

During the war in Afghanistan, the Taliban promised to clear the roadblocks to petty warlords, and in exchange to receive from the transportation syndicates substantial backing, mostly in gold. Donations to the Taliban and Al Qaida from wealthy Saudi backers was also made in gold. When U.S.-led forces occupied Afghanistan, they found Al Qaida training manuals that included not only chapters on weapons and explosives, but sections on how to smuggle gold. Using specially-made vests, gold smugglers can carry up to 80 pounds, worth \$500,000, on their person. Cash is far bulkier. There have also been rewards offered for killing U.S. officials in Iraq, payable in gold.

There are several lessons one can draw about this financing of Middle East terror in West Africa and the terrorist use of commodities. One is that terrorist groups are sophisticated in their exploitation of gray areas where states are weak, corruption is rampant, and the rule of law nonexistent. They correctly bet that Western intelligence services do not have the capacity, resources or interest to track their activities there.

A second lesson is that terrorist groups learn from their own mistakes, as well as from each other. They are adaptable in ways that make them extremely hard to combat. Hezbollah has been using diamonds from West Africa to finance its activities for 20 years. Al Qaida operatives simply plugged into the same network.

The third lesson is that small clues matter in trading terrorist funding and the use of commodities. There has been a limited understanding of the financial structure of Al Qaida and Hezbollah both before and after 9/11. The intelligence community carried out its first comprehensive assessment of Al Qaida's financial structure in 1999, 11 years after the organization came into existence. Rather than understanding the web of commodities, charities and individual donors that filled Al Qaida's coffers, the conventional wisdom was that bin Laden was using his personal wealth to finance his organization's operations.

A fourth lesson is that terrorist networks and criminal networks can overlap and function in failed states like Liberia. Commodities like diamonds are the coin of choice as the different groups provide different services to governments or rebel groups in exchange for cheap access to commodities.

The fifth lesson is that the intelligence community reacts very poorly to information it does not initiate. Thus, much information generated by journalists, the Special Court for Sierra Leone, and others was dismissed out of hand. More than 2 years later, the tide is changing, but if the terrorists's use of commodities is to be understood and effectively cut off, the intelligence community must begin to look beyond the traditional methods of raising and moving money, and begin to look at commodities much more seriously.

Thank you, and I look forward to your questions.

[The prepared statement of Douglas Farah can be found on page 41 in the appendix.]

Chairman KELLY. Thank you, Mr. Farah.

Mr. Factor, certification regimes have enabled Congress and the public to clearly measure how well other countries perform on various issues. They also allow investors to measure how well a market meets the demand for safety and transparency. If a certification regime for terrorist finance were to be put in place, what kind of metric would be the most use to the financial markets?

Mr. FACTOR. That is a very good question. I think that the metrics are fairly simplistic. FATF in the past has looked at rules and regulations against terror financing, but almost no one has looked thoroughly at implementation. I think the implementation metric is absolutely vital. A number of countries have some of the best rules and regulations on their books, but their implementation of those rules and regulations is poor, to say the least.

I think that the implementation of rules, as well as the rules and regulations, would be the key metric.

Chairman KELLY. Thank you very much.

Mr. Farah, your reporting on some of the issues relating to the use of precious stones by Al Qaida in West Africa has been polarizing in some circles. As you well know, some of your assessments and those made by others were not accepted by the 9/11 Commission report on terror finance. I have discussed this with my staff, and apparently they had discussed this with you. You know that

many of us in Congress are trying to approach the issue with an open mind. We simply want to learn more about how this issue might be affecting the financial infrastructure of the groups that are trying to attack us.

Some people I know and deeply respect disagree with your assessments. Others seem ambivalent. They say that you are right; this happened several years ago; it is largely a moot issue so far as our current efforts are concerned. Of course, there are others who would say the same thing that you have. I recall, for instance, a news report from last August in which a senior U.S. intelligence official said, "Charles Taylor was in the back pocket of Al Qaida. He was helping them launder money through the diamond mines."

I noted this morning an article that is in the Detroit Free Press with a headline that says, "Al Qaida has bases in Africa." The opening sentence reads, "Al Qaida has opened recruiting and training bases in Nigeria, Somalia, Tanzania, and Uganda, the United Nations said Tuesday in a report that warned that terror group attacks should be expected to increase." With unanimous consent, I am going to make a copy of this article from the Detroit Free Press a part of this record.

One thing I think that should be clear to everyone is that the issues surfaced by your investigations remind us that there is a very dense cloak of uncertainty that we are trying to pierce in this fight against terrorism. Many parts of this terrorist apparatus cannot be fully seen and they never will be. But some things that we believe to be true dangers may not be provable in a court of law, and I think we have learned that our inability to find fire in certain areas where there is smoke does not mean that we should ignore that thick smoke. We cannot afford to.

I am interested in hearing your thoughts on why some of the central assessments of your book are so important to us right now. Can you give a perspective on why the issues raised by your book and the other writings should warrant continued attention in our fight against terrorist financing, and about why we should have a strong presence in such places such as Africa where we previously may not have had a very robust intelligence operation?

Mr. FARAH. Thank you for the question.

I think you are right. I think that there has been a lot of discussion about the use of commodities, especially diamonds, in the intelligence community. I think that one of the huge differences between the initial reports that were done by myself and others and what has come subsequently is that we actually spent considerable time on the ground, in some cases years, getting to know the structures. It is very hard to send a two-person team in for one week into a country and expect them to come back with an adequate assessment of what actually happened there.

I think there is also a real loss of the sense of the history of what Al Qaida was doing, which you can only gain if you go back and read the trial transcripts and read bin Laden's early writings. If you look at that extensively, you will find that gemstones, especially in the trial of Wadi el Hage and others, are a consistent in huge part with what they talk about. It is not an isolated incident.

Finally, when they expelled a Senegalese man from Germany last year, the BBC asked him if he really knew bin Laden. He said

yes, he had visited bin Laden three times while bin Laden was in the Sudan. They said, why were you doing that? And he said because bin Laden was financing my diamond deals between West Africa and Belgium. It was interesting. The weight of evidence and the things especially the Special Court has come up with, from being on the ground over a considerable period of time varies with the assessment of people who can come and go, or only read someone's intelligence report, especially when your human intelligence in that region is essentially nonexistent.

As to why it is relevant now, I think it points to an MO of terrorist structures. In my mind, it is tremendously significant that Hezbollah has developed this incredible financial apparatus using diamonds out of West Africa that Al Qaida was simply able to plug into across the Shi'a-Sunni divide and into a business thing. What is even more stunning, and I go into it a little bit in my written testimony, is that on the ground in Africa, especially in the DRC and in Sierra Leone, you can find Israelis who are doing business with Hezbollah knowing who each other are and they are perfectly happy to do it because it is business there. It is a way of moving money and generating wealth. It is an MO that is very easy to use and escape public notice of scrutiny.

Finally, I would say that the presence of RUF in Guinea just before Christmas of two South Africans who had initially been arrested with Mr. Ghailani in Pakistan, Ghailani being one of the key people in my book and a key person in the Al Qaida financial infrastructure. When he was arrested in Pakistan in July of last year, these two gentlemen were arrested with him. They were sent back to South Africa. They were freed after 2 days in South Africa. They were arrested in December trying to get from Guinea into Sierra Leone into the diamond fields.

To me, especially presence of Dr. Ganchi who was providing medical attention to Ghailani when he was arrested, and his attempt to get back to the diamond fields indicates that there is a clear threat that this is something that they continue to want to do.

Finally, I would point to the work of the U.S. European Command in the military. They have been on the ground there for a significant period of time and have looked at my reporting and other reporting and their own reporting over the last 3 years. They have come out very strongly and publicly, General Wald and others, that this in fact is happening and is an ongoing threat to us.

So I think it is an MO that these people use and will continue to use because it works. Until you cut it off, they will keep using it.

Chairman KELLY. Thank you.

Mr. Gutierrez?

Mr. GUTIERREZ. Mr. Factor, in your testimony you indicate that the U.S. government should increase its information sharing with the financial services industry under Section 314(a) of the PATRIOT Act. I agree that the filers of CTRs and SARs would benefit from learning what data the government found most useful. I understand that the regulators are working currently on examiner guidance to provide some certainty and consistency between what is said by the policymakers and what is done by the examiners in the field. I urge them to issue this guidance as soon as possible.

Mr. Factor, what information do you believe would be most helpful to the industry, and how do you recommend the information sharing be improved and accomplished?

Mr. FACTOR. First of all, thank you for the question. You are right that there is a need for fair information. You really brought up two separate issues, and I would like to address them both, if I may. One is the CTR issue. In 2003, which is the last available statistic I have, there were over 12.7 million CTRs filed. I have been told by bank representatives that it takes about a half-hour to process each CTR, to put that number in some perspective. The largest floating vessel in the world ever built was the Queen Mary II a few years ago. It took about 6 million man-hours to build that vessel. We spend more than 6 million man-hours on CTRs each year.

The problem I find is that when we ask Treasury specifically if CTRs led to any arrests, convictions or prosecutions, they could not point to a single one. I am not against collecting information. I am against collecting information that cannot be used. Likewise, with respect to the suspicious activity report, SARs, as you brought up, in 2003, again the last full statistic I have, there were over 288,000 of them filled. I cannot imagine how we could follow up on 288,000 SARs.

I think one of the problems is that we are collecting information for the sake of collecting information. Just the sheer collecting this information puts undue burdens on businesses and the American people. I believe that information collection may sometimes be necessary, but it is not necessary if you are not going to do anything with the information.

I am not intimately knowledgeable about FinCEN, but I look at FinCEN as some huge, huge library with stacks of books with no card catalog. It is all there, but if you cannot use, it is not as much value. I think the real key is using the information that we get and figuring out a way. I mean, look at what we are doing with all sorts of logic that is being programmed into things. We have our Silicon Valley, our high-tech industries. We could utilize businesses that have knowledge of how to take information like this and put it into some way that is usable, not just collect it for the sake of collecting it.

Your second part about information sharing, and I think that is one of the key things. Again, I ask you all to please hold a hearing on Section 314 because I think it would be extremely useful, and how to share information for the benefit of the American people. In other industries like the transportation industry and industries like, oh, a number of other industries, we share information that is classified, high-value information. We designate people. I think you are going to have to designate some people. I think the outcome is going to be much more sharing.

I think coming from the Treasury Department, people have to be taught and informed how to use that information and the sharing of information, not just how to follow up on suspects. I do not think the procedures and policies necessary are in place yet, and I think we need to put them in place. I think it is Treasury's obligation to do that, and I believe they eventually will, but I would rather see them do it sooner than later.

Mr. GUTIERREZ. I think we would be well served to look at the section and to have hearings, particularly on this section, because you have over 200,000 SARs filed and maybe trying to find a mechanism so that we can pick what is relevant information. I think bankers are just being very, very careful in following the law, and being careful and if something looks suspicious, let's send it in, when we may not need that information.

Go ahead.

Mr. FACTOR. I am sorry. I do not mean to interrupt you.

First of all, it is almost 300,000 2 years ago. Second of all, some bankers are filing everything but the kitchen sink and others are filing almost nothing. There are no real set policies and procedures. As a member of the New York State Bank Board, I talk to bankers frequently. I think we need leadership and guidance on this issue to a greater degree than we have now. I understand that Treasury is doing a good job and they are moving forward. I think we have to move forward faster and we have to move forward in a more methodical way. I agree with you completely, and I thank you for your interest in this because I think it is vital to stopping the financing of terror.

But remember, if I may have just 1 more second, the only true intelligence in this whole area of terrorism is with respect to money and money equivalents. If we can really begin to use finance intelligence effectively and zero-in on it, we have ways of stopping terrorism. The actual cost of an act of terror is not really the true cost. The true cost is the infrastructure needed for those organizations, and those organizations's resources determine their ambitions. The greater their ambitions, the more resources they develop. We can find them if we follow the money.

Mr. GUTIERREZ. Thank you. My time is up. Thank you very much.

Mr. FACTOR. I apologize.

Mr. GUTIERREZ. No, it is okay. Thank you so much for coming. My time is up.

Maybe we could figure out a way where I get an e-ticket now, it is always good because I used to always lose my ticket. Now I just show my ID. Maybe all these hundreds of thousands of pieces of paper, they do not have to be on paper. Maybe we can figure out a way to electronic them. That is just one instance, because until we do this stuff electronically, we are never going to be able to garner the information and be able to siphon what is really necessary.

Thank you so much for coming, Mr. Factor, and thank you so much for being here this morning.

Chairman KELLY. Thank you, Mr. Gutierrez. I think there are a lot of us who would like to see the paper chase end and go electronic. The problem is the cost of going electronic at this point, I think. We are looking at it, but we have been looking at it. As you know, this committee has been very instrumental in trying to make sure that FinCEN especially has the money it needs to be an electronic agency.

We go now to Ms. Moore.

Ms. MOORE OF WISCONSIN. Thank you, Madam Chair.

I really appreciate this panel for coming forward. Mr. Factor, I was particularly drawn to comments that you made on page two

of your testimony, the fourth paragraph, where it says, "the certification regime should provide for sanctions under Section 311 of the PATRIOT Act, including denial of U.S. foreign assistance monies and limitations on access to U.S. financial systems on nations that do not receive certification. Of course, sanctions would be subject to waiver by the President if required by vital U.S. national interests."

I guess that leads me into the real contradiction that I think Mr. Farah raised in his testimony. This certification regime, how does it deal with, and I am just going to throw out some examples, we talked about Liberia. I mean, they were our buddies, our friends, as long as there were hostilities against the Soviets; Saudi Arabia; we are a debtor nation to China. We need the oil in Nigeria and so on and so forth. The South African diamond industry, in Mr. Farah's testimony he talked about how we did not want to acknowledge that because it would be a blemish on the CIA and we had a relationship with them.

How, in fact, will this certification regime process enable us to certify nations, be they friend or foe, particularly when our vital interests can trump anything else?

Mr. FACTOR. You raise a very good point. In the drug area, Presidential waivers have been used. I think that when you are talking about terror financing, the public will react a little differently, but as important as that is, the fact is that we do not even name and shame those people who are helping finance terror which is killing U.S. citizens. I cannot even imagine not enacting a certification regime for terrorist financing because we want to keep certain issues off the table. I do not think we can any longer keep those issues off the table when our domestic security is involved.

You may want to grant security waivers, but I think the naming and shaming process is the barest minimum step we have to take.

Ms. MOORE OF WISCONSIN. Madam Chair, a follow-up?

Chairman KELLY. Yes, of course. Anytime the green light is on, ma'am, you have that time as yours.

Ms. MOORE OF WISCONSIN. Okay.

Chairman KELLY. But at red, I am going to cut you off.

Ms. MOORE OF WISCONSIN. Yes, ma'am.

I guess I am wondering what sanctions we have against people where we are in their pocket. We owe them; we need their resources; we need their oil. Your testimony seems to suggest that this certification regime process would somehow hold people to task because we would have some sanctions. It is not clear to me what we could do to the examples that I gave. Maybe Mr. Farah might want to jump in, because I am very, very interested in this as a process question.

Mr. FACTOR. Section 311 provides specific sanctions. It provides limitations on access to U.S. financial systems, which is deadly to the financial systems of another country. It would hurt their ability to have a financial system. That is for openers. Sanctions also include denial of U.S. foreign assistance monies. There are a whole host of things that can be done.

What has happened is, we are not in the pocket of a lot of these countries. We have just taken certain issues off the table, which has been going on for multiple administrations. Saudi Arabia is an

example, and there are other countries besides Saudi Arabia. We have to treat them in the way we treated the Soviet Union and later Russia, the way we treat China, where no domestic issues are off the table. In the past, as an example, our relationship with Saudi Arabia was such that we would help with their security; they would help with regional security and oil, and the Palestinian issue. Domestic issues were off the table. Again, this goes back multiple administrations.

The times have changed. Our domestic security is involved. There can be no longer domestic issues which affect us that are off the table. I do not believe we are in anyone's pocket.

Chairman KELLY. Thank you, ma'am.

The Chair would point out that there are certain problems with a public listing of noncompliant countries, not the least of which would be investment by outside companies and some of the ways to pull some of these countries back into cooperation is to make sure that they have a vital stake in a safe world. We can explore that further.

I would like to ask a question of both Mr. Factor and Mr. Farah. The cultural differences in financial institutions can have a powerful affect on intelligence analysis, as I believe the testimony of both of you made clear. I want to know if you have an idea about what steps Congress should be taking to try to foster an understanding of these differences. I am just throwing that out to both of you for an answer. Whoever wants to can go first.

Mr. FARAH. I would say that the first thing that comes to my mind is that, and it is one of the areas that this administration is seeking to remedy quickly, but I think in some areas not in the right geographic areas, and that is I do not think you can do this without good human intelligence. I do not think you can understand the cultural factors and understand, for example, in West Africa, how the Lebanese diaspora community controls through intermarriage and different groups that work together and families that work together, a lot of the commodity trade, not only diamonds, but frozen chickens, wines, and everything.

Until you understand how those relationships work and what the clan structure is that imposes order on certain types of commodity trades, you cannot begin to understand how the actual system works. That is one of the big black holes in the intelligence community's understanding of what goes on in West Africa, because they have never done this type of analysis of how things moves.

I think for Congress, I am not sure what the role would be except to be pushing the community in that direction. I think we also have to be, as several members mentioned earlier, incredibly sensitive to the impact of going after, for example, the hawala system. As people mentioned, millions and billions of dollars flow into Pakistan and India through that system. The people have no other way to receive that, and you could cut that off and bring those economies to a halt, an unintended consequence for a very small trickle of dirty money.

I would also say that in diamonds, you are talking probably in the blood diamond trade that is probably never more than 7 or 8 percent of the diamond trade, of which the terrorists probably took 10 percent of that. You are talking about a minuscule flow of dirty

stuff through largely clean operations. If you take a sledge hammer approach to regulation, you end up ruining a lot more than you end up fixing.

So I would be wary of regulation, and I would say that what Congress's main role perhaps could be is in pushing Treasury and FinCEN and the intelligence community to look at these inter-culturally appropriate ways to regulate, and then coming back with the information they gather.

Chairman KELLY. Thank you.

Mr. Factor, the cultural differences within the financial institutions themselves sometimes have an effect on the intelligence analysis. What would you say to that question about what Congress should be doing to try to take into consideration the understanding and development of the differences?

Mr. FACTOR. There are cultural differences, no question about it, but I think major cultural difference, and this has to be explored and worked on through bodies like the United Nations, is that the notion that any act of terror be legitimized by a charitable activity or some political motivations of the perpetrator has to be completely, totally, not be allowed to be bought into. No cause, however legitimate, justifies the use of terror.

Indeed, the use of terror must delegitimize even the most worthy cause. We should not allow, and our true allies should not allow people to be part of it, countries and jurisdictions to be part of the world community that does not accept that principle.

For us to allow people to be our allies and get away from that principle makes no sense to me. I think that is a foreign policy issue that Congress should be taking up, specifically those differences that you ask about and talk about in many cases have to do with, a lot of these societies are opaque. Things happen in the shadows. As long as things happen in the shadows, then these societies allow this opaqueness to exist with regard to enforcement of rules and regulations, we will never change that culture.

And if we do not change that culture, we will allow breeding grounds for terrorism, and the mother's milk of terrorism, which is money and the financing of terrorism to exist. It is our fault for not pursuing that.

Chairman KELLY. I appreciate the comments from all of you.

This is a very busy day, as you probably noticed people coming in and out from this panel. So the Chair notes that members may have additional questions for this panel. Personally, I have a couple that I am going to submit in writing, and others may wish to submit in writing.

So without objection, the hearing record will remain open for 30 days for members to submit written questions to these witnesses and to place their responses in the record.

I thank both of you for your time this morning. It has been very informative and I hope will be very helpful to us in the long run, both with our dealings with agencies and in drafting legislation.

With that, this hearing is adjourned.

[Whereupon, at 11:56 a.m., the subcommittee was adjourned.]

A P P E N D I X

February 16, 2005

Written Testimony of
Mallory Factor
Before the
Committee on Financial Services
Subcommittee on Oversight and Investigations
United States House of Representatives

February 16, 2005

Chairwoman Kelly, Congressman Gutierrez and Distinguished Members of the Subcommittee on Oversight and Investigations, thank you for inviting me to testify today about my views on terrorist responses to improved financial defenses by the United States.

Chairwoman Kelly, I would like to commend you in particular for addressing head-on the complex issue of the terror financing through your introduction in the 108th Congress last September of H.R. 5124, a terror financing certification regime, and your continued commitment to this issue.

My remarks are informed by the report of an Independent Task Force on Terrorist Financing, sponsored by the Council on Foreign Relations, on which I served as Vice-Chair. Because the report, along with its various appendices, is almost 300 pages in length, I will only be able to highlight certain core points relevant to this Subcommittee and ask that the full report and its appendices be placed into the record. I am testifying in my personal capacity, as is customary, and not on behalf of the Task Force or the Council on Foreign Relations.

I realize that the Members of the Subcommittee are by now well informed about various methods of terror financing through the work of the 9-11 Commission and from the testimony of others that have appeared before you. Therefore, my testimony today will set forth instead constructive, forward-looking recommendations that Congress can undertake to improve U.S. efforts against terrorism financing.

Testimony of Mallory Factor
February 16, 2005

First, U.S. policymakers must build a new framework for bilateral relations with all nations which includes discussion of those “domestic” issues that affect U.S. security but which formerly were considered internal policies and thus, were “off the table”. Many terrorist organizations such as al-Qaeda, a terrorist organization rooted in issues central to Saudi Arabian domestic affairs, conspire to kill Americans and to threaten our way of life. When “domestic” issues of any nation threaten Americans at home and abroad, these issues can no longer be “off the table” in our bilateral relationship—rather, they must be addressed directly and openly.

Second, a Treasury-led certification regime specifically on terrorist financing should be a part of the new framework of directly addressing internal policies of other nations as these policies affect our national security.

A certification regime should require the Treasury Department to provide a written certification on an annual basis (classified in whole or in part, if necessary) detailing the steps each foreign nation has taken to cooperate in U.S. and international efforts to combat terror financing. To be truly meaningful, a certification regime must focus on the extent to which the nation actually implements its laws and regulations and is effective in combating terror financing as well as its enactment and promulgation of new laws and regulations.

The certification regime should provide for sanctions under section 311 of the Patriot Act—including denial of U.S. foreign assistance monies and limitations on access to the U.S. financial system--on nations that do not receive certification. Of course, sanctions would be subject to waiver by the President if required by vital U.S. national interests.

Critics of certification regimes have argued that presidential waivers render such regimes ineffectual because waivers can be overused – as, for example, has been claimed in the drug certification regime context. I believe, however, the high national attention and priority placed on the war on terror will result in a much more effective certification regime for terror financing than for drugs. The paramount importance to the US of preventing and limiting future terror acts imposes an obligation on Congress to preserve the integrity of a terror financing certification regime by limiting or regulating the availability of national security waivers if necessary.

Although the Patriot Act gives the Administration powerful tools against terror financing, my understanding is that the Administration has used its section 311 powers only once in the terror financing context. Section 311 allows Treasury to require domestic financial institutions and agencies to take “special measures” against certain parties, including both institutions and jurisdictions, believed by the Treasury to be engaged in money laundering/terror financing. These special measures can include placing prohibitions or conditions on “correspondent” or “payable through” accounts involving the parties engaged in the money laundering/terror financing. A certification regime for terror financing would ensure that the special measures provided by the Patriot Act are used appropriately and thoughtfully against “rogue” jurisdictions.

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Of course, foreign financial institutions and jurisdictions that do not have significant financial relations with the United States would not be meaningfully impacted by Section 311 sanctions triggered by non-certification. It should be noted, however, that a similar sanction imposed in the money laundering context resulted in the targeted jurisdiction immediately promulgating desired legislative and regulatory changes.

A separate certification regime for terror financing – distinct from any other reporting requirements on the promulgation of terror itself or money laundering – ensures that stringent requirements are maintained—and revisited annually—with respect to each jurisdiction’s practices on terror financing.

With respect to the terror financing certification regime proposed by Chairwoman Kelly, U.S. News and World Report reported on October 4, 2004, “the State Department appears unenthused because it could end up citing allies like Indonesia, Nigeria, and the Philippines.” A certification regime is required precisely because the U.S. policymakers may choose to minimize diplomatic friction by avoiding criticism of the policies of certain other nations. A certification regime would require the Executive Branch to review on an annual basis the policies and progress of each nation on the subject of terror financing, without regard to whether such nation is a so-called “ally” of the United States.

Third, Congress must also consider how financial support for the export of radical Islam or *Wahabism* around the world fits in with the U.S. agenda on curbing terror financing. Congress appears to have reached a consensus that providing support for terrorist training camps and infrastructure constitutes “terror financing” along with support of the direct costs of carrying out terror acts. Congress may need to explore how support for *madrassas*, mosques, cultural centers, other institutions and the training and export of radical clerics pose a threat to US interests. These institutions and clerics radicalize millions of Muslims around the world and quite possibly, create the next generation of terrorists. The fact that financial support for these institutions may be motivated by sincere and deeply held religious and philanthropic beliefs on the part of some donors makes this inquiry very difficult. Still, Congress should seriously consider whether or not nations and individuals that support the export of radical Islam can really be our “allies”-- or actually constitute indirect financiers of terror that pose a strategic threat to the U.S.

Fourth, additional coordination is required by the Administration on terror financing. The Administration has made progress in coordinating U.S. measures to combat terrorist financing through the Office of Terrorism and Financial Intelligence (TFI) at the Department of Treasury, and I commend the Administration for this effort. Because decision-making on the war on terror is centralized in the National Security Council (NSC), a position needs to be added at the White House for a person specifically responsible for terror financing so that this issue is fully integrated in the broad discussions of and decisions on how to prosecute the war on terror. A formal allocation of responsibility to this position in the terror financing area should be formalized through a National Security Presidential Directive (NSPD) or otherwise.

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Fifth, the U.S. government should increase sharing of information with the financial services sector as permitted by Section 314(a) of the PATRIOT ACT so that this sector can cooperate more effectively with the U.S. government in identifying terror financiers. Helping private sector financial institutions become effective partners in identifying financiers of terror should be a top priority. The procedures set forth in Section 314(a) of the Patriot Act, which promote information sharing between the U.S. government and financial institutions to increase detection of terror financing, are not working as well as they should. Banking industry officials tell me that the U.S. government is still not providing financial institutions with adequate information to enable the institutions to detect terror financing and identify unknown perpetrators. The government is using financial institutions primarily to assist in investigating known or suspected terror financiers, not in identifying unknown ones. Very little information is flowing from the government back to financial institutions that spend considerable resources on compliance with the government's information requests. In addition, our government does not currently have the appropriate resources to process and make full use of information that is flowing to it from financial institutions.

I recognize that the information that would enable financial institutions to become effective partners with the U.S. government in identifying terror financing may be highly protected intelligence information. In other industries such as defense and transportation, however, persons can be designated by the U.S. government to receive access to certain high value information as necessary. A similar approach could be used to facilitate information sharing and cooperation between the U.S. government and private financial institutions. I would encourage this Subcommittee to hold an oversight hearing on Section 314 of the Patriot Act to determine how more effective procedures for information sharing with financial institutions can be developed and implemented.

Sixth, the National Security Council (NSC) and the White House Office of Management and Budget (OMB) should conduct a cross-cutting analysis of the budgets of all U.S. government agencies as they relate to terrorist financing. Monitoring the financial and human resources that are actually devoted to the various tasks involved in combating terrorist financing will facilitate fully informed, strategic decisions about whether resource allocations are optimal or functions are duplicative. For this reason, the NSC and OMB should conduct a cross-cutting analysis of all agencies' budgets in this area, to gain clarity about who is doing what, how well, and with what resources. With an appropriate cross-cut in hand, the Administration and Congress can begin to assess the efficiency of existing efforts and the adequacy of appropriations relative to the threat.

Seventh, promoting understanding of cultural differences in finance systems required for useful intelligence gathering should be the work of cooperative efforts between the U.S. government and private foundations, universities, and think tanks. At the dawn of the Cold War, the U.S. government and U.S. nongovernmental organizations committed substantial public and philanthropic resources to endow Soviet studies programs across the United States. The purpose of these efforts was to increase the level of understanding in this country of the profound strategic threat posed to the United States by Soviet

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Communism. A similar undertaking is now needed to understand the methods and modalities of the financing and global propagation of radical Islamic militancy which I believe constitutes the greatest strategic threat to the United States at the dawn of this new century.

I look forward to your questions.

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Testimony of Douglas Farah

Feb. 16, 2005

"Terrorist Responses to Improved U.S. Financial
Defenses"

Before The

House Subcommittee on Oversight and Investigations

Committee On Financial Services

Thank you, Chairman Kelly, for the invitation to talk today about the role of commodities in terrorist financing. I believe it is an extremely important area that has not received the attention it deserves from the intelligence and law enforcement communities, either before or after 9-11.

Commodities such as gold, diamonds and tanzanite have played a vital role in the global terrorist infrastructure. Gemstones have played a particularly important role in al Qaeda's financial architecture. Diamonds, in particular, have been used to raise money, launder funds and store financial value. Gold, for a variety of cultural and logistical reasons, has been used primarily as way to hold and transfer value. These commodities are not tangential to the terror financial structure, but a central part of it.

Diamonds have also been used extensively by Hezbollah and other terrorist groups in the Middle East that have a long tradition of access to diamonds in West Africa through the Lebanese *diaspora* there.¹

Since the late 1990s, diamonds and tanzanite have played an important role in both financing terrorist activities and helping terrorists move their money outside the formal financial sector.² Gemstones are ideal for

several reasons: they hold their value; they are easy to transport; they do not set off metal detectors in airports; and they can be easily converted back to cash when necessary. This is especially true of "blood diamonds," or diamonds mined by armed groups, mostly in sub-Saharan Africa, in order to finance their wars. Diamonds mined in these areas are outside government control, where illicit trade has flourished for years and where it is easy for clandestine structures to operate while drawing little attention from the law enforcement or intelligence communities.

Al Qaeda sought to exploit gemstones in West Africa, East Africa and Europe almost since its inception. Al Qaeda, the Taliban and the Northern Alliance all exploited Afghanistan's emerald fields to finance their activities, so gemstones were not an unknown revenue source.

There is strong evidence of al Qaeda's ties to the African diamond trade, despite the reluctance of some in the U.S intelligence community to acknowledge the link. The data comes from the testimony of al Qaeda members convicted of the 1998 U.S. embassy bombings in East Africa; my own investigations into the ties in West Africa, particularly to Charles Taylor in Liberia and his allies in the Revolutionary United Front (RUF) in Sierra Leone;

investigations by the London-based NGO Global Witness; Belgian police investigations; and most recently, a growing body of evidence accumulated by the U.N.-backed Special Court for Sierra Leone, charged with investigating crimes against humanity in that brutal conflict. In two reports presented to some members of Congress, the Court's chief prosecutor and chief investigator—each with 30 years experience in the Department of Defense—have summarized the large volume of evidence of these ties from sources that are different from and independent of other investigations. I would be happy to provide members of the committee with any of these documents.

Groups like al Qaeda and Hezbollah chose West Africa as a base because in states such as Liberia, Sierra Leone and most others in the region, governments are weak, corrupt and exercise little control over much of the national territory. Some states, like Liberia under Charles Taylor, were in essence functioning criminal enterprises. For the right price, Taylor let al Qaeda, Russian organized crime, Ukrainian organized crime, Balkan organized crime, Israeli diamond dealers and Hezbollah, operate under his protection. Yet Taylor's regime could still issue diplomatic passports, register aircraft, issue visas and enjoy the benefits accorded to a sovereign government.³

Because of this, Taylor issued airplane registrations to Victor Bout, one of the world's largest illegal weapons dealers. Bout was later discovered not only to be selling weapons to most sides of most civil wars in Africa, but also to the Taliban AND the Northern Alliance in Afghanistan. He often took his payment in diamonds. Until very recently he was also flying for the U.S. military in Iraq.⁴

The documentary and anecdotal evidence point to two distinct phases in al Qaeda's diamond activities. The first started sometime before 1996, when bin Laden lived in the Sudan, and was aimed at helping finance the organization. The latter years overlap with the large-scale, al Qaeda dominated purchase of tanzanite in East Africa.

Wadi el Hage, bin Laden's personal secretary until he was arrested in September 1998, spent a great deal of time on gemstone deals. During his trial in New York, El Hage's file of business cards, personal telephone directory and handwritten notebooks were introduced as evidence. He was sentenced to life in prison for his role in the East Africa bombings. The notebooks contain extensive notes on buying diamonds, attempts to sell diamonds, and appraising diamonds and tanzanite. There is a page on Liberia, with telephone numbers and names. His address book and business

card file were full of the names of diamond dealers and jewelers, many containing the purchaser's home phone number.

It is not clear how profitable al Qaeda's gemstone ventures were. What is clear is that the efforts to acquire gemstones, particularly diamonds, were frequent, widespread and a matter of priority of al Qaeda.

In late 1998, following the al Qaeda attacks on the U.S. Embassies in Nairobi, Kenya and Dar-es-Salaam, Tanzania, al Qaeda moved to the second phase of its diamond operation. The impetus was the Clinton administration's successful freezing of some \$240 million in assets belonging to Afghanistan's Taliban government and bin Laden, the rogue regime's guest. The move caught both the Taliban and al Qaeda by surprise because they apparently did not realize the money, mostly held as gold reserves in the United States, could be targeted.⁵

The picture of al Qaeda's activities in West Africa changed dramatically in the latter half of 2000, when senior al Qaeda operatives arrived in Monrovia, Liberia. Having set up a monopoly arrangement for the purchase of diamonds through Taylor with the RUF, al Qaeda buyers went on a spree that lasted several months. But here the intention was not to make money, but rather to buy the

stones as a way of transferring value from other assets. In order to do this, the al Qaeda operatives were paying a premium over the going rate for uncut stones, leaving regular buyers without any merchandise to purchase.

What is particularly interesting during this phase was the collaboration between Sunni and Shi'ite Muslims. While al Qaeda operatives on the ground supervised the trade, the middlemen handling the diamonds were Shi'ite. Further muddying the waters as the collaboration between Islamists in the West African diamond trade, with Israeli diamond merchants. Despite the war in their homelands, both Israeli and Lebanese diamond merchants continue to do business with each other. There are numerous other documented cases of al Qaeda-Hezbollah cooperation, but the tie in the financial field is relatively unexplored.

The pace of the al Qaeda purchases picked up beginning in January 2001 and lasted until just before 9/11. Telephone records from the middlemen handling the purchases shows telephone calls to Afghanistan up to Sept. 10. The available evidence points to al Qaeda purchasing some \$20 million worth of RUF diamonds during the 14 months prior to 9/11.⁶ The evidence suggests a rapid, large-scale value transfer operation that allowed the terrorist group to move

money out of traceable financial structures into untraceable commodities.⁷

In the terrorist financial architecture, the use of gold is different than that of precious stones. Gold seems to be used primarily to store value and facilitate the movement of money across the world's financial markets.

Cultural and regional factors made gold a favorite commodity of both the Taliban and al Qaeda. Much of the money they had was stored in gold. In the waning days Taliban control of Afghanistan, Sheik Omar and bin Laden sent waves of couriers carrying gold bars and bundles of dollars--the treasury of the country and the terrorist movement--across the porous border of Afghanistan into Pakistan.

From the Afghan-Pakistan border area, the money and gold were consolidated and taken by trusted couriers to the port city of Karachi, Pakistan. There, the Taliban consul general Kaka Zada oversaw the movement of the wealth to the desert sheikdom of Dubai, United Arab Emirates. The transfer to Dubai relied on couriers and the virtually untraceable, informal money transfer system known as *hawala*, a method widely used across the Middle East, North Africa and Asia. Zada also personally acted as a courier at

least once, taking \$600,000 in a diplomatic pouch to Dubai in late November 2001.⁸

Such money movements are not unusual. Pakistani officials estimate that \$2 million to \$3 million a day are hand carried from Karachi to Dubai, a flight of less than an hour. But in the three weeks from the end of November to mid-December there was a large spike in the amount of money traveling that route, reaching \$6 million to \$7 million a day. Once in Dubai much of the wealth of the Taliban and al Qaeda was converted to gold bullion and scattered around the world. Gold, unlike cash, is exempt from almost all reporting requirements that govern currencies, making it much harder to trace.

Demand for gold in India and Pakistan is extremely high for religious, cultural and legal reasons. Gold has significance in ceremonial rites for Hindus, and is widely used for dowries in marriages. But for centuries gold has also been the preferred medium of exchange for businessmen and traders on the Indian subcontinent. Gold is a traditional hedge against inflation, hoarded as a security against times of high inflation or hardship. The annual demand for gold in India is estimated by Interpol, the international police agency, to be an astonishing 800 metric tons, almost triple that of the United States.⁹

Because gold imports into both Pakistan and India have traditionally been restricted and subject to high tariffs, gold smuggling from Dubai, where the gold trade is unregulated, has been enormously profitable for decades. Dubai's location is ideal, making it a nexus of myriad smuggling networks that flow through Iran, India, Pakistan, the Arab world, to Afghanistan and Central Asia.

During the war to control Afghanistan, the Taliban was broadly backed by Pakistani and Indian businessmen who wanted a single authority to guarantee their merchandise could move by truck across Afghanistan. The Taliban promised to clear the roadblocks of petty warlords, and in exchange received from the transportation syndicates substantial financial backing, much of it in gold.

Donations to the Taliban and al Qaeda from wealthy Saudi backers were also often made in gold.¹⁰ When U.S.-led forces occupied Afghanistan they found al Qaeda training manuals that included not only chapters on how to build explosives and clean weapons, but sections on how to smuggle gold either on small boats or concealed on the body. Using specially-made vests, gold smugglers can carry up 80 pounds, worth up to \$500,000, on their person. Cash is far bulkier.¹¹

Gold continued to play a vital role in al Qaeda finances in recent times. In the summer of 2002, elite European intelligence units monitoring al Qaeda's movements forwarded an alarming report to their U.S. counterparts: Al Qaeda and the Taliban were shipping large quantities of gold through Karachi to Sudan. The gold was being sent by boat to either Iran or Dubai, where it was mixed with other goods and flown by charter airplanes to remote airstrips in Sudan. The gold was obtained through a "commodity-for-commodity exchange," Pakistani intelligence officials said, meaning heroin and opium stashed by the Taliban and al Qaeda was traded to drug traffickers for the precious metal. The gold was packed in boxes and represented only a small portion of the cargo on each charter flight. Estimates of the value of the gold ranged from several hundred thousand dollars to several million.¹²

Sudan was familiar territory for bin Laden, and his history there has been retold often. But it is worth a brief recap.

In April 1991, he had moved there with several hundred combatants, welcomed by the fundamentalist Islamic government, the National Islamic Front. Bin Laden even married into the family of NIF leader Hassan al Turabi, wedding Turabi's niece.¹³

In May 1996, under heavy pressure from the United States and anxious to rehabilitate its international image, Sudan asked bin Laden to leave, and he returned to Afghanistan. However, many of bin Laden's businesses in Sudan remained active and he remained close, economically and politically, to many leaders of the NIF. Bin Laden "has banking contacts there, he has business contacts there and he is intimately familiar with the political and intelligence structure there," said a European intelligence official. "He never fully left Sudan despite moving to Afghanistan."¹⁴

There are several lessons one can draw about the financing of Middle Eastern terror in West Africa and the terrorist use of commodities.

One is that terrorist groups are sophisticated in their exploitation of "gray areas" where states are weak, corruption is rampant and the rule of law nonexistent. They correctly bet that Western intelligence services do not have the capacity, resources or interest to track their activities there.

A second lesson is that terrorist groups in these areas learn from their own mistakes as well as each other. They are adaptable in ways that make them extremely hard to

combat. Hezbollah has been using diamonds from West Africa to finance its activities for at least 20 years, perfecting smuggling routes to Europe and Lebanon, developing a network of middle-men and successfully embedding its financial structure within the diamond trade. Al Qaeda operatives plugged into the same network.

A third lesson is that small clues and critical analysis matter in tracing terrorist funding and the use of commodities, but there has been a limited understanding of the financial structure of al Qaeda and Hezbollah before and after 9/11. The intelligence community carried out its first comprehensive assessment of al Qaeda's financial structure in 1999. The 9/11 Commission found the same to be true for the entire intelligence community in looking at al Qaeda's organizational structure. Rather than understanding the complex web of commodities, charities and individual donors that filled al Qaeda's coffers, the conventional wisdom in the intelligence community was that bin Laden was using his personal wealth to finance his organization's operations.

A fourth lesson is that terrorist networks and criminal networks can overlap and function in the environments of failed states, like that of Liberia. Commodities like diamonds are the coin of choice as the

different groups provide different services to governments or rebel groups in exchange for cheap access to commodities.

A fifth lesson is that the intelligence community reacts very poorly to information it does not initiate. Within the culture of the community, the assumption was that the initial diamond stories made the CIA look bad, and therefore had to be attacked. So was the information passed on by Special Court for Sierra Leone investigators. More than two years later the tide is changing. But if the terrorist use of commodities is to be understood and effectively cut off, the intelligence community must begin to look beyond the traditional methods of raising and moving money, and begin to look at commodities more seriously.

There are several steps that must be taken to begin to combat the use of commodities by terrorists.

The weapon most often brandished, but that is the least effective, is to institute new, sweeping regulations on commodity traders. This will simply drive even legitimate businessmen underground or out of business. New regulatory burdens to halt the fraction of illegal activities that benefit terrorists in the diamond industry, gold trade or *hawala* transactions would hurt millions of

people. This is especially true of the *hawala* system, which primarily benefits millions of families in India and Pakistan who live off the remittances sent through this system by family members working on the Arab Peninsula.

What is really needed is the most difficult and time consuming to carry out: building up intelligence-gathering capabilities on the ground in the "grey areas" or "stateless areas" of the world where the illicit commodity trades flourish and where terrorists have made significant inroads. These areas include parts of West Africa, much of the Democratic Republic of the Congo, parts of East Africa and swaths of Southeast Asia. Only specific information gathered at the points of origin in the commodities trade can really help monitor and decipher how the businesses operate.

For example, in Sierra Leone, Liberia and the DRC, a network of Lebanese diamond traders, related by family and political ties, have traditionally moved the bulk of the "blood diamonds." These kinship networks that are central to this commodity trade need to be mapped and understood as a first step toward defining what action can be taken. It is also essential to understand these groups, operating in areas of the world where computers and telephone communication is haphazard at best, rely on personal

contacts, family ties and couriers for much of their operating structure. High-tech monitoring of their communications, successful against other types of groups, is much less useful in these circumstances.

The intelligence deficiencies are not surprising. At the end of the Cold War, no region of the world suffered more dramatic intelligence cuts than sub-Saharan Africa. More than one-third of the CIA stations were eliminated entirely and those that remained were left with only minimal staffing. Even as the Clinton administration began increasing funding for intelligence in the late 1990s, the region's capabilities and budget remained static.¹⁵

As the capacity to monitor events on the ground is being rebuilt, there are steps that can have an impact. The most urgent is to begin to seriously work with the commodity industries themselves. There is a knowledge base there that can be tapped into, because many of the important players are not only concerned about terrorists' use of their commodity. They also want to clean up their image. While unwilling to act as government agents, many in these communities are willing to share information and ideas on how to clean up and safeguard particular trades. This is important because these groups are small and know

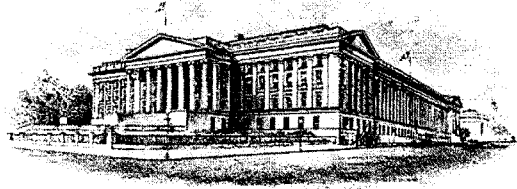
the players. Many are anxious to help put the more disreputable elements out of business.

Nicky Oppenheimer, chairman of the De Beers Group and an important voice in the diamond community, has recognized that the terrorist threat is real. In March 2004 he said that among the greatest challenges facing the diamond and jewelry industry "is the vulnerability of the industry, as with other commodities, to misuse and abuse by criminals and the perpetrators of terror...In a world where our personal security, that of our families and communities, is under real and present threat, we must take notice and take action."¹⁶

Efforts to deprive terrorists of their funds means, necessarily, depriving them of their safe havens. The new havens are in parts of the world we have long ignored, the spreading swaths of stateless territories and rogue regimes. Until we recognize this and begin to understand the true nature of terrorist finance, their money will continue to flow.

Given the nature of the transactions, the growing pace of globalization and the untraceable nature of these transactions, they are likely to remain an integral part of terrorist financial structure for the foreseeable future.

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- ¹ For a fuller discussion of the Lebanese role, including that of Hezbollah and the Amal militia, please see Lansana Gberie, *War and Peace in Sierra Leone: Diamonds, Corruption and the Lebanese Connection*, The Diamond and Human Security Project, Occasional Paper 6, January 2003. Also, Harris, Edward, "Hezbollah Extorting Funds From West Africa's Diamond Merchants," *The Associated Press*, June 29, 2004.
- ² For a fuller discussion of al Qaeda's ties to the tanzanite trade, see Robert Block and Daniel Pearl, "Underground Trade: Much Smuggled Gem Called tanzanite Helps bin Laden Supporters," *Wall Street Journal*, Nov. 16, 2001, p. A1. For a description of al Qaeda's ties to the diamond trade, see Douglas Farah, "Report Says Africans Harbored al Qaeda," *Washington Post*, Dec. 30, 2002, p. A1; also Global Witness, *For a Few Dollars More: How al Qaeda Moved into the Diamond Trade*, London, 2003.
- ³ Farah, *Blood From Stones*, op cit.
- ⁴ Braun, Stephen, Judy Pasternak and T. Christian Miller, "Blacklisted Russian Tied to Iraq Deals; The Alleged Arms Broker is Behind Four Air Cargo Firms used by U.S. Contractors, Officials Say," *The Los Angeles Times*, Dec. 14, 2004, p. A1.
- ⁵ Daniel Benjamin and Steven Simon, *The Age of Sacred Terror*, Random House, New York, 2002, p. 289.
- ⁶ Belgian police report, "Case LIBI," obtained by author.
- ⁷ Farah, *Blood From Stones*, op cit.
- ⁸ This information was obtained through interviews with knowledgeable sources in Pakistan and Dubai, and first reported by me in the *Washington Post* Feb. 17, 2002, pg. A1, "Al Qaeda's Road Paved With Gold."
- ⁹ Interpol Report, Gold Smuggling and the Drug Trade in Southwest Asia, obtained by author
- ¹⁰ Confidential author interviews
- ¹¹ Farah, *Washington Post*, op cit
- ¹² Douglas Farah, "Al Qaeda Gold Moved to Sudan," *Washington Post*, Sept. 3, 2002, page A1.
- ¹³ Prof. Eric Reeves, leading Sudan expert, Smith College, North Hampton, MA., e-mail communication, Feb. 20, 2003
- ¹⁴ Farah, *Sudan*, op cit
- ¹⁵ Author interviews with intelligence officials. Also, Farah, Douglas, *Blood From Stones: The Secret Financial Network of Terror*, Broadway Books, New York, 2004.
- ¹⁶ Address of Nicky Oppenheimer, chairman, De Beers Group, to the World Diamond Council Third Annual Meeting, Dubai, March 30, 2004.



**DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS**

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**Testimony of
Juan Carlos Zarate, Assistant Secretary
Terrorist Financing and Financial Crimes
U.S. Department of the Treasury
Before the House Financial Services Committee
Subcommittee on Oversight and Investigations**

Chairman Kelly, Ranking Member Gutierrez, and distinguished members of the Subcommittee, thank you for this opportunity to appear before you today and discuss the abuses by terrorists of non-traditional means of financing and the U.S. government's efforts to combat them. This is an important and complex issue, and I applaud the Subcommittee for its continued focus on the changing face of terrorist financing. The Treasury Department particularly appreciates the leadership you have provided, Madam Chair, on this and related issues.

Since September 11th, we have concentrated our attention on financially isolating those who support terrorism while building systems and capacities in the international financial system to heighten the risk and cost associated with moving tainted capital. Through an unprecedented global effort to shut down flows of money to Al Qaida and like-minded terrorist groups, it is now harder, costlier and riskier for terrorists to raise funds for their attacks. Terrorist assets and conduits of funding have been frozen, shut down or otherwise neutralized. Key facilitators have been captured or killed; otherwise sympathetic donors have been deterred or isolated, and through training and technical assistance we have increased the capacity of our global partners to combat terrorist financing.

In addition to concentrating on the formal mechanisms used by terrorists and criminals to hide sources and eventual uses of money, we have known and addressed the various informal ways that terrorist groups around the world raise and move money. We have applied a consistent approach to dealing with the relevant systemic risks attendant to different sectors of the international financial system – both formal and informal – in order to bring greater transparency and accountability to financial transactions globally. To this end, we have supported and encouraged the worldwide expansion of the regulatory oversight to previously unregulated sectors, garnered more information from the newly regulated communities, and applied enforcement pressure where needed to help ensure compliance. In many respects, these efforts have shone the light of day on previously unseen or untended corners of the financial world.

Throughout this period, there has been a growing realization internationally that securing the financial system and all vulnerable sectors – in addition to targeting the sources of terrorist support – is an essential element of our fight against terrorism and financial crimes. We must continue to build upon this strategy and systemic platform to reduce the risks associated with the movement of money in the less formal sectors of the international financial system.

Al Qaida and like-minded terrorist groups and their supporters will constantly search for the weak links in the preventative systems that are put in place in the United States and around the world. Thus, we are challenged to innovate ways of securing the international financial system and disrupting the financing that fuels terror, without doing damage to the workings of the free markets. This challenge extends to the less formal and previously unregulated sectors of the international economy.

THE EVOLVING THREAT

In the world of counter-terrorism, we are constantly facing new challenges and evolving threats. In this realm, we know that terrorist groups of all stripes use a variety of mechanisms to raise and move money. Al Qaida has used charities and deep-pocket donors to raise and move money. Hamas holds fundraising events, where like-minded individuals are invited to contribute funds ultimately meant for terrorist activities. The terrorist cell that launched the devastating attacks on Madrid's train system raised money through drug dealing. In the United Kingdom, terrorists engage in bank robberies to acquire ready cash. Colombia's notorious FARC, ELN, and AUC narco-terrorists maintain drug cartels and kidnapping operations in order to support their terrorist operations. Still others, like Hezbollah, ETA, and Jemaah Islamiyah, employ front companies and phony businesses to funnel cash or extortion taxes meant to subsidize their terrorist networks.

These are just some examples that point to the real challenges that we face. Now more than ever, it is clear that terrorist financing is not a monolithic force - but part and parcel of a nexus comprised of adept financial criminals, corruptible financial institutions, and complex ideological and financial networks. The terrorist financing threat is evolving. Terrorist financiers are constantly adjusting to international efforts to obstruct them and consistently depend on new and innovative ways to bankroll the terrorist infrastructure.

U.S. and multinational victories against Al Qaida have had a scattering effect, meaning that some of our terrorist enemies have dispersed into new and incongruous clusters. As Al Qaida balkanizes, the organizations and those localized cells that are aligned with it are relying on additional and differentiated sources of financing to survive and proliferate. These sources, we have found, include the corruption or abuse of the charitable sector and various forms of financial crime. The means of moving money across borders also varies – to include the use of cash couriers and hawaladars.

INFORMAL AND ALTERNATIVE FINANCIAL SYSTEMS VULNERABLE TO USE BY TERRORISTS AND CRIMINALS

In the larger campaign against terrorist financing, the U.S. government has focused not simply on the formal financial systems used to raise and move money but on the alternative mechanisms relied upon by terrorist groups around the world to help support their activities. In a sense, as the U.S. government and its partners – in the public and private sectors -- have made it more difficult for terrorist financiers and money launderers to use banks, terrorist groups have begun to rely even more so upon less formal methods to move money.

One of the alternatives terrorists have employed to move money is frequently termed as alternative remittance systems (ARS) -- also known as informal value transfer systems (IVTS), parallel banking, or underground banking. In a sense, referring to these alternative systems as “non-traditional” is somewhat misplaced. It is more precise to think of these as systems outside of any regulated financial system at

all. In fact, many of the so-called “non-traditional” systems we are talking about today are quite traditional within the cultures and norms of daily business in various corners of the world. There are a variety of non-traditional “systems.” Some of them, such as hawala and the Black Market Peso Exchange, are well-known to this Subcommittee. Others, such as trafficking in precious gems and the laundering of diamonds are gaining increased recognition. These diverse systems, however, do have commonalities. Virtually all of them may use trade to transfer value or provide counter valuation in order to “balance the books.” In addition, we have found that these networks operate and depend on trust. Unfortunately, this high degree of trust, often based on long-standing ethnic, family, clan or tribal ties, obstructs those trying to understand and investigate these networks and design effective policies and countermeasures to terrorist and criminal abuse.

Our approach with these sectors has been to bring them into the light of the regulatory world – through laws and outreach – and to enforce, with the help of the appropriate agencies, including the federal regulatory agencies and the Department of Justice and the Department of Homeland Security, those laws and regulations accordingly to ensure a culture of compliance with recordkeeping, due diligence, and broad anti-money laundering controls. Increased transparency and accountability, concomitantly, enhances our ability to target corrupted actors within these systems.

Charities

Perhaps the most important non-traditional method used by terrorist organizations to raise and move funds and otherwise support terrorist activity is through the corruption and abuse of charities. Numerous instances have come to light in which mechanisms of charitable giving have been used to provide a cover for the financing of terror. In certain cases the charity itself was a mere sham that existed simply to funnel money to terrorists. However, often the abuse of charity has occurred without the knowledge of donors, or even of members of the management and staff of the charity itself. Besides direct financial support, some charities also provide cover and logistical support for the movement of terrorist operatives, and others facilitate terrorist recruitment by disseminating terrorist agendas or ideologies.

Curtailing such corruption and abuse is a critical element of our general national and international strategy to combat terrorist financing, as underscored in the 2002 and 2003 National Money Laundering Strategies, numerous USG counter-terrorism strategies, and various international resolutions and standards. Efforts across the U.S. government have produced considerable results in the form of targeted actions to identify, disrupt and dismantle terrorist financing through charitable organizations. The U.S. has designated five U.S.-based charities, including thirty-five additional international charities for terrorist financing activity; prosecuted the leader of a U.S.-based charity for fraud and racketeering based on terrorist financing activity; indicted the charity and its leadership on terrorist financing-related charges; and investigated dozens if not hundreds of additional charities suspected of terrorist financing activity. Many of these investigations are ongoing.

These successful targeted actions are the product of sustained interagency coordination and collaboration. We are also engaging in coordinated efforts to improve our systemic oversight, investigation, outreach and international capabilities. At the federal level, oversight and transparency of the charitable sector is a primary concern of the Tax Exempt and Government Entities Operating Division (TEGE) of the Internal Revenue Service (IRS). TEGE examines and recognizes charities that qualify for tax exempt status, based on information submitted by charities in their application forms and annual returns. The civil examiners in TEGE have a unique familiarity with the charitable sector and the reporting, recordkeeping and disclosure obligations of the sector under the federal income tax laws. This experience is critical to the criminal investigative efforts of the Criminal Investigative Division (CID) of the IRS. The IRS has established a number of mechanisms to ensure that TEGE and CID appropriately communicate and work together on potential cases involving terrorist financing. For example, TEGE has recently revised the application form for tax-exempt status for charities (Form 1023) to include more relevant investigative information for criminal investigators in terrorist financing

and criminal cases. TEGE has also established a Screening Center to process leads from all sources, including state and local officials, on potentially abusive charities. Finally, TEGE has created a Media Relations Screening Office to identify and examine public reports on abuses within the charitable sector.

Experience gained during the past two years has also identified areas where CID can have a greater impact addressing terrorism related financial issues without duplicating the efforts of any other law enforcement agency. CID has created a Lead Development Center (LDC) to pilot a counter-terrorism project focusing on charitable abuse by using advanced analytical technology, along with subject matter experts, to support ongoing investigations and proactively identify potential patterns and perpetrators. The LDC is comprised of a staff of CID Special Agents, investigative analysts, and representatives from TEGE, who research investigative leads and field office inquiries concerning terrorism investigations. The LDC integrates its work within the larger U.S. law enforcement community, largely through CID representatives on Joint Terrorism Task Forces (JTTFs) led by the FBI. The target information packages developed by the LDC are sent to the JTTF or IRS field office that requested the analysis and to such other law enforcement entities as may be appropriate and consistent with the statutory limitations on disclosure.

The LDC also serves as a central point to de-conflict related investigations among multiple IRS field offices, and is developing distinctive analytical capabilities to include link analysis, data matching, and pro-active data modeling. Using data from tax-exempt organizations and other tax-related information that is protected by strict disclosure laws, the LDC can analyze information not available to or captured by other law enforcement agencies. By combining that data with public source information and data gathered by other criminal investigations, the LDC can perform a complete analysis of all financial data pertinent to specific targets and restrict its dissemination as required by the tax disclosure laws and the rules of grand jury secrecy. This research, technology, and intuitive modeling, coupled with CI's financial expertise, will help maximize the impact of CI resources against sophisticated terrorist organizations.

Internationally, we are working with our counterparts in Finance Ministries around the world to promote better oversight, investigation and protection of charities from terrorist abuse. Through the Financial Action Task Force (FATF), we have issued a Best Practices Paper to FATF Special Recommendation VIII (SR VIII), describing steps that charities and governments can take to attack and protect against terrorist abuse. We have also launched an internal review process through the FATF's Working Group on Terrorist Financing to improve member countries' understanding of their charitable sectors and to identify existing strengths and weaknesses in combating terrorist abuse of charities. We are globalizing this process by extending this exercise to the FATF-style regional bodies. Based on the conclusions drawn from this exercise, we are now working with our counterparts in the FATF to develop further interpretive guidance to SR VIII, which will strengthen the capabilities and commitments of member states in combating terrorist abuse of the charitable sector. We are also continuing to work with the interagency community to deliver bilateral assistance to countries to improve their oversight and investigation capabilities with respect to the charitable sector.

In addition to these oversight, investigative, international, and information-sharing efforts, the Treasury Department is engaged in sustained outreach with the charitable sector to develop protective measures against potential terrorist and criminal abuse of the sector. In April 2004, the Treasury Department hosted an Initial Outreach Event with representatives from across the charitable sector to discuss Treasury's Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities and related issues of terrorist financing in the charitable sector. Based on this meeting, the Treasury Department is continuing to work with the sector to refine these guidelines and develop better feedback for the sector on terrorist financing issues. The Treasury Department is also working with private sector watchdog groups in the charitable sector to promote awareness of terrorist financing issues and to expand this oversight mechanism to vulnerable donor and charitable communities. Finally, Treasury is also working with other U.S. agencies and the charitable sector to examine ways of promoting charitable

assistance abroad by reducing the threat of terrorist abuse. We will continue to work with the interagency community and the charitable sector to ensure that our resources, authorities and relationships are fully applied to attack and protect against terrorist abuse.

Hawalas

Hawala is a “non-traditional” value transfer system, which does not rely on the physical movement of money in order to transfer value across borders between trusted hawaladars (or brokers). Instead, transactions are conducted between trusted networks or brokers in a manner that allows the fluid delivery of cash or valued goods to remote parts of the world, which are often not yet accessed by the banking system. These transactions tend to be recorded by hawaladars with some diligence for business recordkeeping purposes, and settlements of the debts owed are often conducted via trade transfers or bank transactions.

Although overwhelmingly used for legitimate purposes such as the remittance of immigrant wages, hawala networks have also been utilized by those who finance terrorism, and their previously unregulated and informal status around the world made this sector particularly vulnerable to abuse. Treasury is confronting the potential misuse of this hawala system at multiple levels.

Internationally, we have worked with international counterparts to expand the regulation of hawaladars overseas. Within the Financial Action Task Force, we worked in October 2001, to ensure that the international community would begin to address terrorists’ abuse of alternative remittance systems. We helped establish and have driven the implementation of the FATF’s Special Recommendation (SR) VI. SR VI states that each country should ensure that individuals and entities that provide money transmission services are licensed or registered and otherwise subjected to the international standards on combating money laundering and terrorist financing, represented by the FATF 40 Recommendations and Nine Special Recommendations. This important step effectively globalized the international effort to extend government oversight to alternative remittance systems.

This effort has been taken on in other international fora. In May 2002, the Central Bank of the United Arab Emirates hosted the first international conference on hawala to discuss their characteristics and to coalesce an international approach to dealing with this unregulated sector. The resulting Abu Dhabi Declaration on hawala called for countries to put in place effective but not overly restrictive regulations on the practice of hawala. As a result, the United Arab Emirates and other countries like Pakistan have established regulatory systems – including licensing and registration program -- for the large hawala community. Progress in the UAE and other countries towards bringing the hawala system into the light of government supervision and oversight was further discussed and internationalized at 2nd Hawala Conference in Abu Dhabi last year and will continue this April at the 3rd Annual Abu Dhabi Conference on hawala.

Domestically, we have instituted federal regulations to cover the registration of money service businesses, to include hawalas in the United States. As part of the process of registration, we have engaged in a public outreach campaign to make the registration requirements known (especially in ethnic communities), and the law enforcement community has taken appropriate steps to target and prosecute unregistered money service businesses. The process of bringing into the regulated community a previously unaddressed sector of the financial system is still underway, and a major challenge for us remains the identification and registration of the hawala sector in the United States.

Black Market Peso Exchange (BMPE)

The BMPE – which is a trade-based system of moving value -- is another alternative value transfer system, used primarily in South America and the Caribbean. This system is often associated most closely with the financing and laundering of proceeds for narcotraffickers in Colombia. BMPEs have

become popular transit points for drug lords to launder their money from U.S. dollars to Colombian pesos.

This trade-based innovation has now been relied upon for a generation. Drug money laundering used to be conducted simply through large deposits of cash into US banks that were then wire-transferred to Colombian institutions. But as U.S. and international authorities cracked down, the drug traffickers were forced to innovate and turned to peso brokers to subvert new controls meant to stop them. Corrupt peso exchanges would sell the drug cartels' U.S. dollars to Colombian businesses, who would then buy American goods. Once the American goods were resold, this time for Colombian pesos, the companies could pay the broker back. After taking a healthy commission for his work, the peso broker could then return the pesos to the drug cartels themselves.

This is a cycle of dangerous money laundering that U.S. and international authorities have been fighting since the 1990's, through investigations, led by the Department of Homeland Security's Immigration and Customs Enforcement (ICE), prosecutions, and effective money freezes. There have been numerous studies of this system, and its longevity is a testament to its efficiency and usefulness to those attempting to evade a host of laws and taxes. The efforts to ferret out the illicit transactions among legitimate trade in the region are now enhanced by greater due diligence on currency exchange houses and suspicious trade transactions – as well as by heightened standards in the region related to money laundering and terrorist financing.

Cash Couriers

Another terrorist financing threat exists in the movement of bulk cash across borders, and particularly, the use of illicit cash couriers. As our efforts choke off terrorists' ability to abuse the formal financial sector and informal value transfer systems, Al Qaida and other terrorist groups have increasingly resorted to cash couriers to move their funds across borders in advance of terrorist objectives and operations.

Treasury and the interagency community, particularly ICE, have worked with our international partners to identify and attack the illicit use of cash couriers and the smuggling of bulk cash. On October 22, 2004, FATF issued Special Recommendation IX (SR IX), under which member countries should ensure that they have measures in place to detect the physical cross-border transportation of currency and bearer negotiable instruments. SR IX also, among other things, provides that countries should have competent authorities in place to stop or restrain currency and bearer negotiable instrument movements suspected of being related to terrorist financing or money laundering. Moreover, countries must maintain appropriate sanctions to deal with individuals that make false declarations or disclosures regarding the movement of bulk cash or bearer negotiable instruments. To further assist countries in developing and implementing effective measures to identify and intercept illicit cash couriers and bulk cash smuggling, we have worked through the FATF to issue an Interpretive Note and Best Practices Paper to SR IX. This guidance will assist our efforts to enhance global capability to attack terrorist financing or illicit finance through cash couriers or bulk cash smuggling.

Precious Commodities

Several reports have underscored the vulnerability of the precious commodities sector as a possible means of terrorist financing. The illicit diamond trade provides an instructive illustration of how terrorists could abuse the precious commodities industry to fund their efforts. The diamond industry describes the movement or flow of diamonds from the point of origin to the point of final use as a "pipeline." Unfortunately, the legitimate diamond processing steps of mining, trading, cutting, polishing, and retailing can be abused by corrupt regimes and criminal organizations to place, layer, and integrate illicit diamonds. To combat these risks, we must improve the oversight and transparency of the diamond and precious commodity industries through the development of effective international

standards and domestic regulation, and we must identify and disrupt illicit actors within the system through targeted actions.

The U.S. government and the international community have worked together with industry to establish international standards that address the particular concerns regarding “conflict” diamonds used to finance wars and other criminal or violent activity. The resultant Kimberley Process is an excellent example of industry, government, and NGO partnership that has helped focus attention and regulatory countermeasures on conflict diamonds.

The Kimberley Process defines guidelines in an effort to document the movement of rough stones through the diamond pipeline and to limit trade to countries participating in the Kimberley Process. The Kimberley Process requires that each shipment of rough diamonds being exported and crossing an international border be transported in a tamper-resistant container and accompanied by a government validated Kimberley Process Certificate, which is uniquely numbered and includes the description of the shipment’s contents.

The latest Kimberley Process plenary meeting that took place in Canada in October 2004 noted significant progress in the implementation of the Kimberley Process Certification scheme. Kimberley Process Participants now encompass the overwhelming majority of the producers and traders in rough diamonds. Although the Kimberley Process has made notable progress in counteracting the trade in conflict diamonds, the procedures were not designed specifically to combat diamond laundering or other financial crimes associated with diamonds. For example, the trade in rough diamonds and the mixing of parcels before being imported into a country for finishing and sale is a recognized vulnerability. There are reports that in some locations that Kimberley certificates can be purchased on the black market. Moreover, the trade in polished stones is not subject to the Kimberley Process.

The Treasury Department is responding to identified gaps in the prevention of financial crimes related to precious commodities, particularly concerns of potential terrorist financing, through sustained industry outreach and the development of effective regulation. In March 2004, William Fox, the Director of Treasury’s Financial Crimes Enforcement Network (FinCEN), addressed the 3rd Annual Meeting of the World Diamond Council, in Dubai. Director Fox and other Treasury officials have subsequently been engaged with industry representatives in other forums. This continuous dialogue has informed Treasury’s ongoing development of a rule extending anti-money laundering obligations to dealers in precious commodities, including diamonds.

FinCEN published a notice of proposed rulemaking in the Federal Register on February 23, 2003. The proposed rule set forth minimum anti-money laundering programmatic requirements applicable to dealers in precious metals, stones, or jewels to prevent money laundering or terrorist financing. This includes formal risk-based policies and procedures, with internal controls, reasonably designed to prevent the dealer from being used to facilitate money laundering or the financing of terrorist activities. Dealers are also encouraged to adopt procedures for voluntarily filing Suspicious Activity Reports with FinCEN and for reporting suspected terrorist activities to FinCEN. FinCEN will be issuing a final rule shortly.

In addition to these outreach and oversight measures, Treasury is also working with the interagency community to identify and shut down illicit financiers who have penetrated the diamond and precious commodity industries in support of criminal activities. Under Executive Order 13348, the Department is pursuing economic sanctions against members of the former Charles Taylor regime and a number of its supporters who financed criminal and terrorist activity through engagement in the diamond and timber industries, including a key Taylor supporter — the Russian-based arms trafficker Viktor Bout. Arguably the largest private arms dealer in the world today, Bout uses his fleet of Soviet-era cargo aircraft to supply guns and bullets by the ton, as well as advanced equipment such as attack helicopters to anyone willing to pay his price. In Liberia and elsewhere, Bout’s organization has reportedly

accepted payment in diamonds which can be easily and profitably unloaded in the Middle East or Europe.

All of these efforts – using a variety of tools available to us -- form part of a comprehensive strategy to deal with the vulnerabilities associated with the precious commodities market.

Trade-Related Links

We are determined to combat terrorist financing, regardless of the tactics our enemies choose to employ. As noted above, our varied efforts directed against the abuse of less formal systems and sectors are targeted in several different areas. Treasury recognizes that, similar to other fronts in the war against terrorist financing, there is no single solution or countermeasure. We must use all tools available to bring these sectors into the mainstream while ferreting out those bad actors and transactions that are abusing the systems that millions around the world rely upon for their well being. We have done this under the expansion of the Bank Secrecy Act – as laid out in the USA PATRIOT Act – and with our international engagement, which has led to better systems, capacity, and expectations of financial transparency and accountability.

In all of this, we must recognize that our terrorist enemies and their supporters are not inert but can adapt to the weapons we deploy against them.

With this in mind, we are looking to other financial systems and sectors around the world that could be used not only to skirt financial regulations but also to facilitate criminal activity and possibly terrorism. As I indicated earlier, we have helped usher the concept of financial transparency for the movement of currency and other financial products. Yet we have found that the “non-traditional” methods of transferring value we are concerned with are not adequately captured or monitored by “front door” financial reporting requirements and regulations. It may now be time to address creatively the “back door” of these systems – meaning the misuse of trade, which virtually all of the alternative remittance systems share in common.

Our experiences demonstrate that an effective way to analyze and investigate suspect trade-based activity is to have systems in place that can monitor specific imports and exports to and from given countries. There is growing worldwide recognition of entrenched patterns of trade fraud. For example, the Kimberley Process was created – in part – due to findings that massive quantities of conflict diamonds from non-diamond producing West African countries were being exported to Belgium. The former U.S. Customs Service (now known as ICE) has used the same technique of examining trade anomalies to combat the Colombia black market peso exchange, to examine suspect gold shipments from non-gold producing countries in the Caribbean, and to take enforcement action against the illegal transshipment of textiles.

We will continue to work with our colleagues from throughout the U.S. government, and particularly ICE, to detect trade anomalies that point us to fraudulent value transfers, money laundering, terrorist financing, and other financial crimes.

CONCLUSION

As the war against terrorism moves beyond the initial phases, we must continue to match the adaptations of terrorist financiers, money launderers, and other financial criminals with our own enhanced powers and steadfast resolve. Every day it becomes more apparent that following dirty money and attacking its illicit sources is an essential part of winning the financial war on terrorism. If we scatter the terrorists, deny them cash, and smother their attempts to funnel their ill-gotten gains through the international financial system, we can make their lives all the more miserable, and their despicable efforts all the more powerless.

Madam Chairman, we appreciate the Subcommittee's continued support as we endeavor to further enhance our varied efforts to combat all types of terrorist financing. We look forward to continuing our work with you on these issues, and I am happy to answer your questions.

Diamonds/Overdue regulations:

Section 352 of the USA Patriot Act required all financial institutions to establish anti-money laundering programs. That section further directed Treasury to prescribe regulations outlining the minimum requirements for each type of financial institution. Dealers in precious metals, stones, and jewels are included among the many types of financial institutions under the Bank Secrecy Act.

Our hearing today — indeed your own testimony — identifies the vulnerabilities in the diamond trade to money laundering, and worse, terrorist financing. Yet over three years have passed since passage of the Patriot Act and Treasury has still not issued a regulation requiring diamond dealers to establish an anti-money laundering program. Why has it not been issued in final form? When will it be issued?

We are eagerly looking forward to seeing that final regulation. But even so, the FinCEN proposed regulation only addressed dealers located or operating in the United States. Many of the vulnerabilities you discussed today arise out of operations outside of the United States, in West and South Africa, Dubai, Russia and Beirut. By focusing solely on domestic dealers, aren't you neglecting the root of the problem? What will it take to address the problems in these trading centers?

Mr. Farah's testimony made reference to ongoing dealings between Israeli Diamond Buyers, Hezbollah and al Qaeda in West Africa. We'd like to know specifically what Treasury has done to investigate and thwart these dealings? How many of these tainted diamonds are coming into the US market? What has Treasury done to determine if there are other instances of these groups working together? How will Treasury work with our intelligence agencies to respond? With Israel?

Saudi Arabia trip

I understand that Treasury has sent a delegation over to Saudi Arabia which is there currently. Could you please provide the committee with a list of the Treasury delegation and the titles of the attendees and the role of each on the trip? Are some Treasury employees on an extended detail there? What are they doing?

Seizing Terrorist Assets

How much money in the war on terrorism has been seized or frozen within the last 6 months? According to CRS, in December, 2002, \$120 million had been blocked, but only 20% of that in the last 11 months. The treasury web site indicates that \$142 million has been seized as of December, 2004 so in 3 years it adds up to 22 million. What is Treasury doing currently in this area?

Hawalas

Treasury has repeatedly told us about the importance of concentrating on hawalas. How many cases have been brought against hawalas to date? Hawalas are a Money Service Business, because they are considered money transmitters. So they are required to register. They are required to report SARs. The IRS is responsible for making cases (enforcement of the BSA). If this is a priority for you and the Treasury department why have no cases been made in this area?

There are also numerous Treasury Tax Inspector general reports that cite the IRS "continued failure to review BSA cases." What are you doing to assure this committee that the IRS is doing its job in this area? According to the Tax Inspector General's report of March 2004, titled "Additional Efforts are needed to improve BSA Compliance Program" "the IRS has NO standard criteria for selecting BSA compliance cases". Out of 3,372 BSA cases examined in FY 2002, only 2 percent were referred to FINCEN for civil penalty consideration. Of those 2 percent, no penalties were assessed because of a lack of proper documentation supplied by the IRS. What will you do to rectify this situation?

MSBs

What is the Treasury Department's timetable for issuing guidelines in regards to MSBs and transaction reporting requirements?

Examiner Guidance

As the *American Banker* recently reported, the financial services industry believes there is "a disconnect between the reassurances from officials here [at Treasury] that anti-laundering rules would not be overzealously enforced and the actions of examiners in the field." Treasury has attempted to reassure the banking industry, through its formal communication mechanism (the Bank Secrecy Advisory Group), that this is not the case, and we understand that Examiner Guidance creating consistent standards is currently being reviewed. When will this Examiner Guidance be issued?

Information Security

What steps have you and your employees taken to ensure security of sensitive information on the insecure computer system? Please be specific about what steps have been taken to remove sensitive documents from the Treasury LAN system?

How much money has been spent so far to clean up the hard drive and rid the LAN of secure documents? Please provide us a progress report by the contractor hired to do this, specifying where you are, what the total costs will be, what remedial actions have been taken, any documentation showing the security of the current LAN. Please provide a list of all appropriated and non appropriated sources of funding that has been used to remediate the LAN system as well as any other

technology expenditures in the past two fiscal years. Please provide any study and any other information that Treasury may have that identifies the weaknesses in the system and the actions that need to be taken. What future steps are being taken to ensure the security of the LAN?

What is the status of FINCEN's BSA Direct project? Will the system be fully functional and deliverable on time and within budget?

Please provide any reports or studies that have been done regarding OFAC's IT requirements. Will OFAC be required to make its new secure system part of the insecure departmental office's LAN? Will it be separate? How much will it cost? How much is in the FY06 budget request to pay for it? How do you know the specifications and the cost? Are you working with a contractor?

Please provide a detailed breakout of all modernization efforts of secure computers and LANs at the Department of Treasury, including the \$2.8 million request to support the Treasury Secure Data Network and \$6 million for the TS/SCI network. Please provide any background and material that support these requests.

Structure of Treasury's Terrorist Financing operations

What is the timeline for filling the position of the Assistant Secretary for the Office of Intelligence and Analysis? Given that this office has been vacant since its creation more than two years ago, does this continuing vacancy indicate that this office and its functions are not a priority for Treasury? The NYT article (enclosed) indicates that this problem may be much more widespread, with as many as one-third of senior policy posts at Treasury vacant or about to be vacant. Is this the case and what steps are being taken to address this broader issue of chronic understaffing? Why are so many positions unfilled? How are the funds being used that would otherwise be compensating these workers? How is Treasury functioning with so many positions unfilled?

What is the difference between your responsibilities and the Director of FinCEN and OFAC? What about the Office of Intelligence? Do they report to you? Has this been delegated to you? Please provide any documentation showing a delegation if it exists.

What is the chain of command, starting with Undersecretary Levey? Please provide the Subcommittee with an organizational chart, indicating the offices, chain of command, reporting relationships and responsibilities.

Since the statute clearly shows and your testimony indicated that oversight and policy of FinCEN cannot be delegated, what do you see as your policy or oversight role over FinCEN?

How do you, Mr. Zarate feel about the transfer of the 23 people from OFAC? They in essence are coming from your terrorism side to the intelligence side.

As the policy person how do you divest yourself from the day to day operations of OFAC and FinCEN?

Are you directing requirements or specific targets? How involved are you or the growing treasury staff below you in the day to day targeting and analytical functions of OFAC and FinCEN? You are charged with policy development and some oversight but your office in my opinion was not charged to be operational. Are you operational (directing the day to day targeting and analytical work of OFAC and Fincen.)

How many people work for you directly? Can you tell us what they do above and beyond the mission of OFAC and FinCEN? If they are not operational, wouldn't these FTE positions be utilized for analysts and not use the resources of OFAC whose resource structure and mission are strained by a lack of resources?

With the receipt of nearly \$10 million in FY 05, a 100% increase and an additional 20% in FY06 can you tell us what will all these new policy people do? Are the increases in OFAC and FinCEN who are the agencies on the frontlines in the war on terror receiving equal increases?

Your budget request includes a new general provision at the end of the Treasury Title that requests extra transfer authority of up to 5% between Departmental Offices and FinCEN, 15 days after notification of the Congress. This transfer authority appears to allow for possible additional support of the Department's Terrorism and Financial Intelligence functions.

- What are the Department's plans for utilization of this specialized language proposal?
- With the staffing level of TFI already up almost 20% in FY 2006 over FY 2005 enacted, what is the extent of expected use of this language in support of TFI?
- Has the Department been hampered in the past without access to such authority?

QFRs for the House Committee on Financial Services
Subcommittee on Oversight and Investigations
Testimony of Juan Zarate, Assistant Secretary for Terrorist Financing and Financial Crime
February 16, 2005

Diamonds/Overdue Regulations

Q: Section 352 of the USA Patriot Act required all financial institutions to establish anti-money laundering (AML) programs. That section further directed Treasury to prescribe regulations outlining the minimum requirements for each type of financial institution. Dealers in precious metals, stones, and jewels are included among the many types of financial institutions under the Bank Secrecy Act (BSA).

Our hearing today — indeed your own testimony — identifies the vulnerabilities in the diamond trade to money laundering, and worse, terrorist financing. Yet over three years have passed since passage of the USA Patriot Act and Treasury has still not issued a regulation requiring diamond dealers to establish an anti-money laundering program. Why has it not been issued in final form? When will it be issued?

A: An interim final rule that requires dealers in precious metals and stones to establish anti-money laundering programs is now complete. Please see associated attachment.

Developing a rule that covers such a diverse array of institutions that have never before been subject to BSA regulation is a complex process. As you will see in the interim final rule, we have tried to tailor the rule to those businesses most at risk for abuse by money launderers. Moreover, we have sought to strike a balance between the burdens imposed on these businesses that are covered by the regulation, while ensuring that they implement necessary anti-money laundering controls. In fact, we still have questions about certain aspects of the industry. As a result, we intend to continue to work closely with the industry as they apply the regulation.

Q: We are eagerly looking forward to seeing that final regulation. But even so, the Financial Crimes Enforcement Network (FinCen) proposed regulation only addressed dealers located or operating in the United States. Many of the vulnerabilities you discussed today arise out of operations outside of the United States, in West and South Africa, Dubai, Russia and Beirut. By focusing solely on domestic dealers, aren't you neglecting the root of the problem? What will it take to address the problems in these trading centers?

A: As I explained in both my oral and written testimony, there must be a comprehensive approach to dealing with identified risks of money laundering, such as those associated with the precious stone and commodity industry. This approach includes domestic as well as international efforts. The regulation of U.S. dealers of precious commodities is only one step of the process. Internationally, we must continue to build anti-money laundering standards and practices, engage directly with key jurisdictions, and enlist those in the private sector to build

greater transparency into their business practices and dealings. This is precisely what Treasury has been doing for the past three years through a variety of bilateral, multilateral, and private sector engagements.

Our engagement internationally touches and affects all of the jurisdictions you have mentioned, and we have developed strong working relationships with the Russians, Emirates, Liberians, and Israelis to deal with an assortment of issues related to money laundering and terrorist financing. Just as important, we have been driving the use of targeted financial sanctions that affect this issue, such as our most recent designations of entities and individuals controlled by Viktor Bout, the arms merchant directly tied to Charles Taylor and the conflicts in West Africa. In addition, these efforts must be amplified with our international partners to make the obligations of the Kimberley Process real and effective.

Q: Mr. Farah's testimony made reference to ongoing dealings between Israeli Diamond Buyers, Hezbollah and al Qaeda in West Africa. We'd like to know specifically what Treasury has done to investigate and thwart these dealings? How many of these tainted diamonds are coming into the US market? What has Treasury done to determine if there are other instances of these groups working together? How will Treasury work with our intelligence agencies to respond? With Israel?

A: As indicated during the hearing, the U.S. government is aware of the potential links between diamond trading and terrorist groups. Treasury works with the intelligence and law enforcement communities to ensure that we have all relevant information that allows us to draw links and understand the contours of terrorist financing and organized criminal networks. In this regard, we are constantly looking at information that may be relevant to this effort and working with our foreign counterparts and will continue to focus on vulnerable sectors and regions.

Saudi Arabia Trip

Q: I understand that Treasury has sent a delegation over to Saudi Arabia which is there currently. Could you please provide the committee with a list of the Treasury delegation and the titles of the attendees and the role of each on the trip? Are some Treasury employees on an extended detail there? What are they doing?

A: I have traveled to Saudi Arabia several times, as part of Treasury delegations and as part of larger inter-agency trips. The most recent Treasury visit to the Kingdom of Saudi Arabia taken by a Treasury employee was in support of Congresswoman Kelly's visit. A FinCEN regional expert provided support. In addition, as I testified, IRS agents are rotating on a set schedule to work with the Federal Bureau of Investigation (FBI) and Saudi counterparts on the Joint Terrorist Financing Task Force (JTFTF) in Riyadh.

Seizing Terrorist Assets

Q: How much money in the war on terrorism has been seized or frozen within the last 6 months? According to Congressional Research Services (CRS), in December, 2002, \$120 million had been blocked, but only 20% of that in the last 11 months. The Treasury web site indicates that \$142 million has been seized as of December, 2004 so in 3 years it adds up to 22 million. What is Treasury doing currently in this area?

A: We continue to work diligently to use the tool of designations to isolate terrorist-related individuals and entities financially and to freeze assets. We have now designated 403 individuals and entities under the President's Executive Order 13224. Information available to us indicates that approximately \$2.3 million in additional assets have been frozen worldwide officially pursuant to the formal designations process over the past six months. These totals do not reflect amounts of cash seized in raids or at ports of entry or borders nor do they include amounts unreported publicly by foreign authorities. The totals also do not encompass amounts of assets frozen by virtue of unilateral actions by foreign governments based on their own authorities, investigation, and processes outside of the UN process.

Of the total frozen assets over the past six months, approximately \$787,000 in assets were frozen by the United States. Since the middle of last November, Treasury has designated ten additional names pursuant to Executive Order 13224 and continues to work aggressively with law enforcement, regulators, intelligence agencies and our international partners as well as financial service providers to uncover and freeze the assets of terrorists and their financial backers. We also work with our international partners to make these designations effective.

It is important to note, however, that the amount of assets frozen in bank accounts or seized at any particular moment in time only tells part of the story of our success in disrupting terrorist financing. The designations shut down networks and their connections to the financial system. In addition and importantly, under our sanctions programs, we block transactions on a consistent basis that represent flows of money that are not allowed to fall into the hands of terrorists or their associates. These amounts are not calculated as part of the "frozen" total. Given all of the data not included in the conservative totals we have provided, I believe that we are undercounting the amount of assets that have been incapacitated since 9/11.

Hawalas

Q: Treasury has repeatedly told us about the importance of concentrating on hawalas. How many cases have been brought against hawalas to date? Hawalas are a Money Service Business (MSB), because they are considered money transmitters. So they are required to register. They are required to report Suspicious Activity Reports (SAR). The Internal Revenue Service (IRS) is responsible for making cases (enforcement of the BSA). If this is a priority for you and the Treasury department why have no cases been made in this area?

There are also numerous Treasury Tax Inspector general reports that cite the IRS' "continued failure to review BSA cases." What are you doing to assure this committee that the IRS is doing its job in this area? According to the Tax Inspector General's report of March 2004, titled "Additional Efforts are needed to improve BSA Compliance Program" "the IRS has NO

standard criteria for selecting BSA compliance cases". Out of 3,372 BSA cases examined in FY 2002, only 2 percent were referred to FinCEN for civil penalty consideration. Of those 2 percent, no penalties were assessed because of a lack of proper documentation supplied by the IRS. What will you do to rectify this situation?

A: Hawala is one category of MSB regulated by FinCEN. As such, hawalas are treated legally as one of many types of MSBs. We certainly recognize that hawala, as an informal value transfer system, is particularly susceptible to abuse, as it often functions outside the regulatory structure through an informal network.

Since issuing anti-money laundering obligations and registration requirements for MSBs, FinCEN has been actively engaging in education and outreach to inform MSBs of their regulatory requirements and encourage them to come forward. Separately, FinCEN, the IRS, and law enforcement have teamed up to identify unregistered MSBs and take appropriate action. Circumstances will dictate whether education on MSB registration requirements will suffice or whether law enforcement action should be taken.

FinCEN is working closely with the IRS to improve examination and referral procedures for MSBs, so that circumstances where systemic and willful violations of the BSA are found, appropriate enforcement action can be taken, including the imposition of civil money penalties. We have virtually completed a Memorandum of Understanding, modeled after the agreement FinCEN executed with the Federal banking agencies, to ensure the flow of information between FinCEN and the IRS.

From the aspect of case development, IRS - Criminal Investigation (IRS-CI) has been actively involved with an Informal Value Transfer System (IVTS) Working Group since last year. The three-fold objective of this project is to initiate a nationwide tasking to identify IVTS locations, provide outreach to those discovered, and to prosecute those remaining in non-compliance with BSA regulations or money laundering laws. The group has already developed a collection plan to identify unregistered IVTS, known as hawala in some countries, specifically operating in the United States with connections to 28 countries of special interest listed by the Foreign Terrorist Tracking Task Force (FTTTF). The initial phase of the project - identification of IVTS operators nationwide, will focus on countries that utilize ITVS to move money to and from the United States to and from FTTTF countries.

After the identification of the IVTS locations and scrubbing them for case/intelligence sensitivities, those IVTS sites will be provided to IRS AML groups for compliance audits, and to FinCEN. These audits will occur after the initial and documented outreach by IRS-CI and Bureau of Immigration and Customs Enforcement (ICE) special agents and AML revenue agents.

The outreach is intended to provide a baseline for notification of law relative to future criminal prosecution. IRS-CI believes that this effort will provided the impetus for true compliance in this "underground banking" industry.

Q: How many cases have been brought against hawalas to date?

A: Hawala is an unofficial system of trust-based alternative remittance and money exchange that operates outside of the traditional banking system. These informal value transfer systems are known by a variety of names reflecting ethnic and national origins that predate the emergence of modern banking and other financial institutions. Hawala transfers take place with little, if any, paper trail. Included, among others, are systems such as hawala or hundi, terms commonly used when referring to Indian, Pakistani, and Middle Eastern systems. While traditional financial institutions may at times be involved in certain transactions, more often this system entirely bypasses traditional banks. There are also often interrelationship and blurred lines between several different types of money laundering schemes used by these types of systems. For example, a hawala dealer may simply transport bulk cash to a relative or associate, may use wire remitters, may exchange currency for items of value, and/or use a combination of these methods.

IRS-CI's Management Information System (CIMIS) tracks the broad types of methods of money laundering, but does not specifically isolate hawala as a category. These broad categories are of little value in identifying hawalas, however CIMIS tracks several violations and scheme codes that are specific to the investigation of unlicensed MSBs. These unlicensed MSB codes are consistent with the definition of hawala as an unofficial banking system outside of the traditional banking system, but none specifically has an element for the word "hawala." Accordingly, there have been 261 such criminal investigations opened by IRS-CI. Currently, approximately 100 such investigations are active.

Q: Why have no cases been made in this area to date?

A: The assumption in your question is incorrect. First, there have been Office of Foreign Assets Control (OFAC) related designations under Executive Order 13224 and related law enforcement actions that have resulted in the shutting down of money remitting services in the United States that were connected to hawala operations globally. In addition, there have been eight unlicensed MSB investigations resulting in an indictment where there was involvement with a particular country that was traditionally involved in hawala activity. One of these investigations resulted in the forfeiture by IRS-CI of \$100,000. The special agents involved in these investigations report that the international aspects of the investigations tend to lengthen the time it takes to complete the investigation. In addition, the close-knit communities that form the customer base for hawalas are often difficult to freely access.

From the aspect of case development, IRS-CI has been actively involved with an IVTS Working Group since last year. The three-fold objective of this project is to initiate a nationwide tasking to identify IVTS locations, provide outreach to those discovered, and to prosecute those remaining in non-compliance with BSA regulations or money laundering laws. The group has already developed a collection plan to identify unregistered IVTS, known as hawala in Muslim countries, specifically operating in the United States with connections to 28 countries of special interest listed by the FTTF. The initial phase of the project - identification of IVTS operators

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The outreach is intended to provide a baseline for notification of law relative to future criminal prosecution. IRS-CI believes that this effort will provided the impetus for true compliance in this "underground banking" industry.

Q: Why doesn't IRS Exam audit hawalas?

A: The very nature of hawalas makes identifying and examining them a very difficult task. Hawalas operate under the radar screen within tightly knit, localized ethnic communities in which English is often a second language. They operate in an informal manner sometimes with less orderly or available paper records to evidence their activities and rarely serve a base of more than 1000 people. Because their modus operandi is to operate under the radar screen, they tend not to register as MSBs. Therefore, the IRS faces a daunting task to even identify the existence of a hawala or the identity of the operator. Because conducting an undercover operation is beyond the scope or authority of IRS Small Business/Self-Employed Division (SB/SE) provided by an informant, it is quite unlikely that the civil side of the IRS will be able to identify independently hawalas. The tools available on the civil side are limited in terms of dealing with operators.

This is why a comprehensive approach of education and outreach, registration and regulation, targeted analysis and audits, and well-tailored enforcement is the best way of dealing with hawalas that may pose a risk of money laundering and terrorist financing.

Q: Why doesn't IRS Exam have workload selection criteria to identify which MSBs should be examined?

A: The IRS SB/SE has created an independent BSA organization in its October 1, 2004 restructuring precisely to deal with these kinds of issues. During the past six months, this new organization has made great strides to overcome prior weaknesses in the IRS's BSA operation. The development of better workload selection criteria is one of the issues currently being addressed. BSA's plan for an independent Planning and Special Programs operation (PSP) to identify its own workload (in the past BSA's workload was identified by the same PSP operation which identified Examination workload) has been approved, and is expected to be fully operational by October 1, 2005. In addition, this BSA organization has developed a risk-based workload selection model which is currently being tested in our Western Territory. After that

model is tested, and modified if necessary, it will be rolled out nationally during late FY 05 or FY 06. Finally, one of IRS-CI's Lead Development Centers is also assisting BSA in civil workload identification. In all, these efforts are addressing the workload identification issue.

Q: Why has IRS Referred so few penalty recommendations to FinCEN?

A: As described above, there are several components to the strategy to deal with BSA-related violations. One key effort that must be undertaken initially is to educate those who now fall under U.S. federal laws and regulations as to what their obligations are and to ensure that they become an active participant in the nation's anti-money laundering system. Thus, the IRS and FinCEN jointly determined after the enactment of the USA Patriot Act that the primary emphasis during the initial years would be on education and registration rather than imposition of penalties for other than the most egregious violations.

We have made great strides in this arena. For example, during FY 03, IRS SB/SE conducted 67 seminars and other outreach efforts which reached 4300 participants. During FY 04, IRS SB/SE conducted 105 such outreach efforts which reached 8887 participants. During just the first six months of FY 05, they conducted 94 such outreach efforts which reached 9047 participants. These efforts need to be matched with appropriate registration, and we are currently evaluating further steps we can take to increase registration.

In addition, IRS and FinCEN have now agreed that while education and registration will continue to be an important part of our efforts that it is now time for renewed use of civil penalties as a compliance tool. We expect to see an increase in the number of penalty referrals to FinCEN during the second half of FY 05.

Q: Why has FinCEN rejected those few penalty recommendations which were referred by IRS?

A: The difficulty of sustaining penalty recommendations lies in the fact that the vast majority of the civil penalties require a finding of willfulness that has been defined as the intentional violation of a known legal duty. The USA Patriot Act imposed many new requirements on MSBs. Thus IRS and FinCEN both recognized that during the first years after enactment proving both intent and knowledge would be a difficult task. This is one of the reasons, as discussed above, why IRS and FinCEN agreed after the enactment of the USA Patriot Act that education should be our primary effort rather than imposition of penalties. IRS and FinCEN both agree that the time has now come for greater use of penalties as a compliance tool. Accordingly, after consultation with FinCEN, the IRS developed guidelines for its BSA Examiners that we expect will lead to more penalty recommendations to FinCEN, and a greater likelihood of them being sustained by FinCEN.

MSB

Q: What is the Treasury Department's timetable for issuing guidelines in regards to MSBs and transaction reporting requirements?

A: On April 26, 2005, FinCEN together with the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation, the Office of Thrift Supervision (OTS), and the National Credit Union Administration (collectively, “the Federal Banking Agencies”) jointly issued: “Guidance To Money Services Businesses On Obtaining and Maintaining Banking Services,” and “Interagency Interpretive Guidance on Providing Banking Services to Money Services Businesses Operating in the United States.” These are available on FinCEN’s website, www.fincen.gov, and are included with these answers as an attachment.

In their guidance, FinCEN and the Federal Banking Agencies set forth the minimum criteria to be considered when a bank is determining whether to open or maintain an account for an MSB. Registration with FinCEN, if required, and compliance with any state-based licensing requirements represent the most basic of compliance obligations for MSBs. FinCEN and the Federal Banking Agencies state in their guidance that it is reasonable and appropriate for a banking organization to insist that an MSB provide evidence of compliance with such requirements or demonstrate that it is not subject to such requirements.

Regarding transaction reporting requirements, with limited exceptions MSBs are subject to the full range of BSA regulatory controls including suspicious activity and currency transaction reporting rules. SARs must be filed when a transaction is conducted by, at, or through an MSB and is both suspicious and \$2,000 or more. Issuers, sellers, and redeemers of stored value come under the umbrella definition of MSBs but are not required to file SARs, nor are check cashers at this time. All MSBs are required to file currency transaction reports if the MSB provides either cash-in or cash-out transactions of more than \$10,000 with the same customer in a day.

Examiner Guidance

Q: As the American Banker recently reported, the financial services industry believes there is “a disconnect between the reassurances from officials here [at Treasury] that anti-laundering rules would not be overzealously enforced and the actions of examiners in the field.” Treasury has attempted to reassure the banking industry, through its formal communication mechanism (the BSA Group), that this is not the case, and we understand that Examiner Guidance creating consistent standards is currently being reviewed. When will this Examiner Guidance be issued?

A: Treasury is committed to a fair and balanced approach in enforcing the BSA, but this approach should not be mistaken as a signal that we will not take appropriate and aggressive enforcement actions when appropriate. We are working constantly with our regulatory brethren to ensure that we apply a common approach to the application of BSA requirements. In this vein, revised, uniform exam procedures for examiners are scheduled to be released by FinCEN and the banking regulatory agencies sometime in the next few weeks.

INFORMATION SECURITY

Answers to some of these questions in this section are provided separately since they are labeled as "For Official Use Only".

Q: What is the status of FINCEN's BSA Direct project? Will the system be fully functional and deliverable on time and within budget?

A: BSA Direct is on schedule to be fully operational and available for users in October of this year (16 months after contract award). No changes have been made to system delivery date or to the functionality to be provided on that date. The law enforcement and regulators who currently access the BSA data through FinCEN will be transitioned to BSA Direct beginning in October.

Based on current estimates, we do not anticipate cost overruns beyond 10% of the original estimate.

BSA Direct will provide users with improved access to the BSA data and with state of the art tools with which to retrieve and analyze that data. The data warehousing technology employed by BSA Direct also provides opportunities to standardize and reference the BSA data, thereby improving its quality and usefulness. The design of BSA Direct is flexible, facilitating future improvements and enhancements. BSA Direct is the centerpiece in Treasury's decision to align organizational responsibilities with authorities by centralizing all the processes related to BSA data under the direct control of the BSA administrator, FinCEN.

Q: Please provide any reports or studies that have been done regarding OFAC's IT requirements.

A: OFAC's IT requirements have been defined in the attached report (Report on the Status of OFAC's technology modernization efforts, as provided for in Senate Report 108-342, Transportation, Treasury and General Government Appropriations Bill, 2005, 108th U.S. Congress, 2nd Session, p.131).

Q: Will OFAC be required to make its new secure system part of the insecure departmental office's LAN?

A: OFAC does not have a new secure system. The Department is currently assessing secure capabilities for TFI, which will be separate from the departmental offices' LAN.

Q: Will it be separate? How much will it cost? How much is in the FY06 budget request to pay for it? How do you know the specifications and the cost? Are you working with a contractor?

A: OFAC is not planning a separate secure system but will be using the Department's modernized secure networks. Information related to the specification, cost, and budget for these secure networks is provided below (see section on information security). In addition, the Department is taking action to improve and enhance security on the departmental offices' LAN.

Structure of Treasury's Terrorist Financing Operations

Q: What is the timeline for filling the position of the Assistant Secretary for the Office of Intelligence and Analysis (OIA)? Given that this office has been vacant since its creation more than two years ago, does this continuing vacancy indicate that this office and its functions are not a priority for Treasury? The New York Times (NYT) article (enclosed) indicates that this problem may be much more widespread, with as many as one-third of senior policy posts at Treasury vacant or about to be vacant. Is this the case and what steps are being taken to address this broader issue of chronic understaffing? Why are so many positions unfilled? How are the funds being used that would otherwise be compensating these workers? How is Treasury functioning with so many positions unfilled?

A: The White House has nominated Janice Gardner, as the Treasury Department's Assistant Secretary for OIA. Ms. Gardner currently serves as the Deputy Assistant Secretary for OIA and has been doing a superb job since the creation of OIA of standing up this office and making it functional. Because of her efforts, the ongoing work of staff, and the leadership of Under Secretary Levey, it would be completely inaccurate to state that these issues are not being addressed or that these issues are not a priority. Quite to the contrary. The issue of how best to deal with threats to the U.S. and international financial systems are front and center every day at the Treasury Department. We are working diligently to fill all of the FTEs granted by Congress and are on pace to do so this FY.

I am not in a position to address questions about other vacancies.

Q: What is the difference between your responsibilities and the Director of FinCEN and OFAC? What about the OIA? Do they report to you? Has this been delegated to you? Please provide any documentation showing a delegation if it exists.

A: Please see attached PDF chart, which illustrates the Office of Terrorism and Financial Intelligence's (TFI) delegation of authority.

Terrorist Financing & Financial Crimes (TFFC)

I lead TFFC. TFFC is responsible for developing policies and implementing strategies to safeguard the U.S. and international financial systems from national security threats, including terrorist financing, money laundering, kleptocracy, organized crime, and proliferation finance. As such, TFFC provides strategic guidance to the Secretary in addressing major national security threats. TFFC also works with OFAC and FinCEN to effectuate these goals in a manner consistent with their authorities and responsibilities. In this vein, TFFC staff coordinates and communicates consistently with OFAC and FinCEN staff on all relevant issue areas. Though staff may monitor how key initiatives and issues are being implemented, OFAC and FinCEN are responsible for executing their day-to-day duties.

TFFC also coordinates within the Treasury Department, across the U.S. government, and

internationally to achieve our twin goals of combating terrorism financing and other national security threats and protecting world financial systems against abuse. TFFC leads and coordinates the United States representation at international bodies dedicated to fighting terrorist financing and financial crime such as the Financial Action Task Force and increases our multilateral and bilateral efforts in this field. The office advances international standards, conducts assessments, provides technical assistance and applies protective countermeasures against high-risk foreign jurisdictions and financial institutions. Bilaterally, TFFC works with foreign finance ministries to craft strategies to jointly attack terrorist financing both globally and within specific regions, and with foreign financial intelligence units to establish special channels of information exchange.

FinCEN's mission is to safeguard the financial system from the abuses of financial crime, including terrorist financing, money laundering, and other illicit activity. FinCEN achieves this mission by:

- Administering the Bank Secrecy Act;
- Supporting law enforcement, intelligence, and regulatory agencies through sharing and analysis of financial intelligence;
- Building global cooperation with our counterpart financial intelligence units;
- Networking people, ideas, and information.

OFAC administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction.

Office of Intelligence and Analysis (OIA)

OIA is the second major component of TFI. The overall purpose of this office is to ensure that the Treasury Department properly exploits the vast pools of financial data already collected by the Department and combines that data with the relevant intelligence collected by the intelligence community to create strategic and actionable financial intelligence and analysis to support Treasury's mission and authorities. For example, this analysis is used to designate individuals under Presidential Executive Orders, target corrupt foreign financial institutions under Section 311 of the Patriot Act, guide regulatory policies and compliance, and direct strategic international engagement to set appropriate standards to safeguard the international financial system. OIA's priorities include identifying and attacking the financial infrastructure of terrorist groups; identifying and addressing vulnerabilities that may be exploited by terrorists and criminals in domestic and international financial systems; and promoting stronger relationships with our partners in the U.S. and around the world. A key long-term goal will be to ensure Treasury's full integration into the intelligence community, and ensure that the Secretary's economic and financial responsibilities are supported fully by the intelligence community.

OIA has already begun responding to Treasury's urgent intelligence needs. OIA ensures that Treasury can track, analyze possible financial angles, and then refer their analysis to relevant Treasury and U.S. government components for appropriate action. The Treasury Department plans to continue to develop its analytical capability through OIA in untapped areas, such as strategic targeting of terrorist financial networks as well as analyzing trends and patterns and non-traditional targets such as hawalas and couriers.

Q: What is the chain of command, starting with Undersecretary Levey? Please provide the Subcommittee with an organizational chart, indicating the offices, chain of command, reporting relationships and responsibilities.

A: Please see PDF chart attached, which illustrates the chain of command in TFI.

Q: Since the statute clearly shows and your testimony indicated that oversight and policy of FinCEN cannot be delegated, what do you see as your policy or oversight role over FinCEN?

A: As the Assistant Secretary for TFFC, my role is to develop, coordinate, and ensure execution of policies to address national security threats – terrorist financing, money laundering, kleptocracy, rogue states, drug trafficking, proliferation finance -- through the use of Treasury powers, authorities, and suasion. This includes driving actions to secure the financial system and sectors from criminal taint and abuse and implementing appropriate policies internationally and domestically to address identified or emerging risks to the U.S. and international financial system. In this regard, I rely on all powers and authorities available to the Treasury Department to execute my role, including regulatory, administrative, enforcement, and diplomatic powers. FinCEN's role as the administrator of the BSA and as the U.S. financial intelligence unit is critical to this mission, and I rely on FinCEN to help me fulfill our common goals.

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Q: How do you, Mr. Zarate, feel about the transfer of the 23 people from OFAC? They in essence are coming from your terrorism side to the intelligence side.

A: I provided a direct and complete answer to this question posed by Congressman Gutierrez during the hearing, which is available in the transcripts of the hearing. This transfer is an

important rationalization and consolidation of analytic work and research being done on terrorist financing. The purpose behind this effort is to make the whole of the Office of TFI greater than its parts. Congress created OIA within Treasury to serve as the hub for such activity and coordinator of all relevant intelligence analysis in the Department. The OFAC transfers to OIA – to which this question refers – represents an important step in making OIA functional in this regard, and the analysts who now sit as members of OIA are some of the most important members of our team. Their work will not only continue to serve OFAC’s mission of administering our sanctions program with respect to terrorist financing, but they will serve as the cornerstone to providing the policymakers within Treasury with a full range of analysis on issues of concern in the realm of terrorist financing, money laundering, and financial crimes.

Q: As the policy person how do you divest yourself from the day to day operations of OFAC and FinCEN?

A: As Assistant Secretary of TFFC, the Under Secretary and I set strategic direction and policy for the Department and work with OFAC and FinCEN to achieve these goals in a manner consistent with their authorities and responsibilities. In part, my role is to ensure proper coordination and use of Treasury resources and powers to achieve our common objectives. In this vein, TFFC staff coordinates and communicates consistently with OFAC and FinCEN staff on all relevant issue areas. Though I monitor how key initiatives and issues are being implemented, OFAC and FinCEN are responsible for executing their day-to-day duties.

Q: Are you directing requirements or specific targets? How involved are you or the growing Treasury staff below you in the day to day targeting and analytical functions of OFAC and FinCEN? You are charged with policy development and some oversight but your office in my opinion was not charged to be operational. Are you operational (directing the day to day targeting and analytical work of OFAC and FinCEN)?

A: As stated above, OFAC and FinCEN are expected to execute their day-to-day duties along with helping achieve the broader policy goals set out by the Under Secretary. In this context, I am not directly involved with the day-to-day operations of either. That being said, it is certainly the case that with specific emerging issues and concerns – be they terrorist financing in nature or otherwise – I do get directly involved in ensuring that the Treasury Department is doing everything possible to address those concerns, within the bounds of our power and resources. Admittedly, TFFC is not “operational”, but we are responsible for ensuring the proper establishment and execution of terrorist financing policy and objectives, among other policies.

TFFC is responsible for developing policies and implementing strategies to safeguard the U.S. and international financial systems from national security threats, including terrorist financing, money laundering, kleptocracy, organize crime, and proliferation finance. As such, TFFC provides strategic guidance to the Secretary in addressing major national security threats. TFFC also works with OFAC and FinCEN to effectuate these goals in a manner consistent with their authorities and responsibilities. In this vein, TFFC staff coordinates and communicates

consistently with OFAC and FinCEN staff on all relevant issue areas. Though staff may monitor how key initiatives and issues are being implemented, OFAC and FinCEN are responsible for executing their day-to-day duties.

TFFC also coordinates within the Treasury Department, across the U.S. government, and internationally to achieve our twin goals of combating terrorism financing and other national security threats and protecting world financial systems against abuse. TFFC leads and coordinates the United States representation at international bodies dedicated to fighting terrorist financing and financial crime such as the Financial Action Task Force and increases our multilateral and bilateral efforts in this field. The office advances international standards, conducts assessments, provides technical assistance and applies protective countermeasures against high-risk foreign jurisdictions and financial institutions. Bilaterally, TFFC works with foreign finance ministries to craft strategies to jointly attack terrorist financing both globally and within specific regions, and with foreign financial intelligence units to establish special channels of information exchange.

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OFAC administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction.

Q: How many people work for you directly? Can you tell us what they do above and beyond the mission of OFAC and FinCEN? If they are not operational, wouldn't these FTE positions be utilized for analysts and not use the resources of OFAC whose resource structure and mission are strained by a lack of resources?

A: TFFC currently has a total of 25 FTEs, including myself, who are responsible for developing and implementing strategies to safeguard the U.S. and international financial systems from national security threats, including terrorist financing, money laundering, kleptocracy, organized crime, and proliferation finance. This includes not just establishment of these policies, but coordination within Treasury, in the U.S. government, and internationally to achieve our national security goals. This is a much different role than OFAC, which administers the 29 sanctions regimes for the U.S. government and FinCEN, which administers the BSA.

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Q: With the receipt of nearly \$10 million in FY 05, a 100% increase and an additional 20% in FY06 can you tell us what will all these new policy people do? Are the increases in OFAC and FinCEN who are the agencies on the frontlines in the war on terror receiving equal increases?

A: TFI staff in general remain on the frontline in the war on terror. TFFC staff, along with others, spend countless hours at home and abroad (often in dangerous locales) to drive our counter-terrorist financing and anti-money laundering strategies. In this regard, the American taxpayers' dollars are well spent on a lean organization that has huge multiplier effects.

With respect to the additional budget, TFFC's personnel will continue to focus on setting and implementing anti-money laundering and counter-terrorist financing policies. Specifically, the new resources will be used to focus on the following:

- Ensuring compliance and effective actions in the campaign against terrorist financing and money laundering throughout the world, with particular focus on key bilateral and multi-lateral engagements.
- Addressing large-scale corruption and asset recovery efforts.

- Building expertise on payment systems, financial institutions, non-bank financial institutions, and e-currencies and Internet-based money movement.
- Driving policies to affect proliferation of weapons of mass destruction.
- Increasing private sector outreach, especially abroad.
- Ensuring proper reporting and implementation of the 2005 National Money Laundering Strategy, the Terrorist Financing Report, and other such reports and documents.

As noted above, the role of TFFC is distinct from the roles played by OFAC and FinCEN. The budgets for OFAC and FinCEN are sufficient to help them address the challenges particular to their offices.

Q: Your budget request includes a new general provision at the end of the Treasury Title that requests extra transfer authority of up to 5% between Departmental Offices and FinCEN, 15 days after notification of the Congress. This transfer authority appears to allow for possible additional support of the Department's Terrorism and Financial Intelligence functions.

- *What are the Department's plans for utilization of this specialized language proposal?*
- *With the staffing level of TFI already up almost 20% in FY 2006 over FY 2005 enacted, what is the extent of expected use of this language in support of TFI?*
- *Has the Department been hampered in the past without access to such authority?*

A: The referenced authority is intended to provide the Under Secretary for the Office of Terrorism and Financial Intelligence (TFI) with the flexibility to shift resources within TFI as appropriate to respond to emerging crises and areas of concern. The issues of terrorist financing, financial crime, and other threats to the financial system are rapidly evolving and require flexibility. To the extent that this authority is restricted or denied altogether, it will hamper TFI's ability to respond adaptively, in the most resource-efficient manner possible, to the ever-changing tactics of terrorists and other threats.

At present, there are no plans to use this transfer authority. To our knowledge, prior to TFI's creation, the Department has not had such authority. The authority augments the purposes expressed by Congress in creating TFI, namely, that the Department to employ a strategic, coordinated, multi-component approach to terrorists and other national security threats

Economic Posts Unfilled Despite Big Pushes Ahead

By EDMUND L. ANDREWS and ELIZABETH BECKER
The New York Times

WASHINGTON, Feb. 24 - Even as President Bush pursues a sweeping agenda to overhaul Social Security and the tax code, his economic team is thinner now than at any time since he took office.

About one-third of the senior policy positions at the Treasury Department, which is central in both the tax and Social Security battles, are empty or about to be.

The office of the United States trade representative, which is in the midst of global and regional trade negotiations, is being led by a caretaker, and Mr. Bush has yet to nominate a permanent trade representative.

And though Mr. Bush announced Wednesday that Harvey S. Rosen would be chairman of the Council of Economic Advisers, Mr. Rosen is expected to return to his teaching post at Princeton by summer's end.

Administration officials said they were pushing to fill the top economic jobs quickly, and people close to the administration said they were close to filling at least one major spot at the Treasury Department.

But at least some of Mr. Bush's supporters worry that the sluggishness in making nominations will close what they see as a narrow window of opportunity to push major initiatives through Congress.

"The first 12 months are really the most crucial," said Stephen Moore, president of the Free Enterprise Fund, a conservative advocacy group that is campaigning for Mr. Bush's plan to partly privatize Social Security.

People close to the administration said that several potential candidates had said they were not interested in leading the tax policy team at the Treasury Department.

In some cases, the reasons were personal and financial. But one former White House official speculated that some people may have been discouraged by perceptions that the department had less power under Mr. Bush than under other presidents.

Whatever the reason, the gaps in Mr. Bush's lineup affect an array of major domestic and international economic initiatives.